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Supreme Court, U.S.
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No. 87-

In The

Supreme Court of the United States

OCTOBER TERM, 1987

In the Matter of:

ELLINGSEN MacLEAN OIL CO., INC.,
and related cases,

Debtors.

UNSECURED CREDITORS' COMMITTEE
and MOBIL OIL CORPORATION,

Petitioners,

v.

FIRST NATIONAL BANK & TRUST
COMPANY OF ESCANABA and
THE NORTHERN TRUST COMPANY

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether the protections of §364(e) of the Bankruptcy Code, 11 U.S.C. §364(e), apply to all provisions of a bankruptcy court order that, in part, authorizes postpetition financing and grants liens securing said postpetition financing, but that also includes cross-collateralization provisions pertaining to liens securing prepetition debt.

2. Whether a creditor has advanced funds pursuant to a bankruptcy court financing order in good faith where said creditor precipitated the emergency nature of the hearing held prior to entry of the order and said creditor knew the findings of fact supporting the propriety of the entry of the order were without any support in the record.

PARTIES

Mobil Oil Corporation, petitioner, is a wholly-owned subsidiary of Mobil Corporation, a Delaware corporation.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioners respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (App. 1a) is reported at 834 F. 2d 599. Its order denying rehearing and rehearing en banc (App. 40a) is not officially reported.

The opinion of the District Court (App. 18a) is reported at 65 Bankr. 358. The order of the Bankruptcy Court (App. 31a) is unreported.

JURISDICTION

The judgment of the Court of Appeals was entered on November 30, 1987 (App. 17a). A timely petition for rehearing and rehearing en banc was denied on January 14, 1988 (App. 40a). The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED

Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, Title I, §364, 92 Stat. 2549, 2574, as amended by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, Title II, Subtitle B, §257(l), 100 Stat. 3088, 3115 is set out in the appendix (App. 45a - 46a).

STATEMENT

These bankruptcy cases involve thirteen related debtor corporations which filed their respective bankruptcy petitions for reorganization under the Bankruptcy Reform Act of 1978, as amended, 11 U.S.C. § 101 *et seq.* ("Bankruptcy Code"), in the United States Bankruptcy Court for the Western District of Michigan, Northern Division ("bankruptcy court") on February 6, 1984. These cases were immediately consolidated for purposes of administration only. These debtors in possession ("debtors") supply, among other things, home heating oil to customers in the Upper Penninsula of Michigan and northern Wisconsin.

The principal secured creditors of these debtors, First National Bank of Escanaba and Northern Trust Company ("banks"), had loaned the debtors over $4,000,000 prepetition pursuant to loan transactions beginning in October, 1981. The loan documents evidencing these loans indicate that the great majority of this prepetition indebtedness involves loans made to only one of the debtors, Bay De Noc Oil Company ("Bay De Noc"). However, as security for these loans to only Bay De Noc, the banks were granted security interests in all of the assets of *all* of the debtors, including the twelve other debtors that had not received the loans. Thus, the loan documents suggest a challenge to the banks' prepetition security interests in all of the assets of all of the other twelve debtors on fraudulent conveyance grounds pursuant to §548 of the Bankruptcy Code, 11 U.S.C. § 548.[1] A successful challenge on fraudulent conveyance grounds would set aside the banks' security interests in the assets of the other twelve debtors to the extent of these loans, possibly enabling these assets to be available to satisfy the claims of the unsecured creditors.

After the filing of the bankruptcy petitions, various postpetition financing orders were entered by the bankruptcy court whereby the banks extended postpetition financing and received liens securing these postpetition advances. All of the postpetition financing orders specifically preserved all rights to challenge the banks' *prepetition* security interests. The Unsecured Creditors' Committee ("Committee") had insisted upon these reservations in contemplation of the clear fraudulent conveyance challenge evidenced by the banks' own loan documents. Furthermore, the right to challenge the banks' prepetition security interests was of paramount importance to the unsecured creditors here as it appeared that the value of the priority tax claims being asserted against these debtors and the

[1] Section 548 permits the avoidance of a transfer of an interest of the debtor in property if the debtor received "less than reasonably equivalent value" in exchange for the transfer. For the loans made to only Bay De Noc, the loan documents indicate that the other twelve debtors may have fraudulently conveyed security interests in their assets to the banks by not having received a "reasonably equivalent value" in exchange for the security interests.

value of the banks' secured claims exceeded the total value of the assets of these debtors. Thus, if a successful reorganization of these debtors could not be accomplished, the unsecured creditors would not receive any payment on their claims unless the banks' prepetition security interests could be set aside.

In April, 1984, after negotiations by the banks with the Committee over the Committee's insistence upon preserving its right to challenge the banks' prepetition security interests, the debtors, with the banks' support, brought a motion for substantive consolidation of these cases, seeking a merger of the assets and liabilities of all thirteen debtors into a single bankrupt entity. The Committee, Mobil Oil Corporation ("Mobil"), and other unsecured creditors opposed the motion on the grounds that substantively consolidating the debtors would take away the fraudulent conveyance challenge to the banks' prepetition security interests.[2] After a two-day hearing the bankruptcy court denied the motion, concluding that although the substantive consolidation would be "of great benefit" to the debtors, the potential prejudice to creditors in denying them the opportunity to challenge the banks' security interests was "too great" to permit substantive consolidation. Bankruptcy Court Opinion, Substantive Consolidation, December 19, 1984, at 5 (App. 41a). The court ruled that the debtors could renew the motion to consolidate when "later litigation establishes the secured creditors' claims of a secured position in all of the collateral of all of the entities." *id.*

Nearly eleven months after the filing of the bankruptcy petitions, the debtors wanted additional financing from the banks. The banks agreed to provide this financing *only* if the banks' *prepetition* security interests were deemed properly

[2] With substantive consolidation, all assets and liabilities of all the debtors would be merged into a single bankrupt entity. *See, e.g., Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966). By merging all the debtors into one entity, the loans made to only Bay De Noc would be deemed to have been made to all of the debtors, precluding a finding that the other twelve debtors that had not received the loans had not received a "reasonably equivalent value" in exchange for the security interests granted.

perfected and not subject to challenge. On December 20, 1984, the debtors, with the support of the banks, filed a Petition for Authority to Settle Stay Litigation, To Amend Agreed Order, and to Obtain New Credit ("Petition"), and the proposed financing order to be entered by the bankruptcy court if the Petition were granted. To insure that their conditions for advancing any additional postpetition credit were met, counsel for the banks had drafted prior to the hearing the proposed financing order that the banks were insisting would have to be entered by the bankruptcy court before the banks would advance any further funds. A hearing on the Petition and proposed order was held by telephone the next day. Telephonic notice of the hearing was given to counsel for the Committee, Mobil, and one other creditor the day before the hearing. Copies of the Petition and of the proposed financing order were received by counsel for the Committee the afternoon of the hearing and reviewed moments before the hearing.

As a result of the hearing, the bankruptcy court reluctantly agreed to enter the proposed financing order that is the subject of the underlying appeal ("amended order") (App. 31a). The amended order allowed the debtors additional financing from the banks in the form of $60,000 in immediate credit and an additional $175,000 letter of credit. To secure these new postpetition advances, the banks were given super-priority liens pursuant to §364(c) of the Bankruptcy Code. In addition, however, the amended order conclusively established the validity of the banks' *prepetition* security interests and conclusively precluded a fraudulent conveyance challenge under §548 of the Bankruptcy Code to the banks' *prepetition* security interests.[3] The bankruptcy court agreed to enter the amended order over the vociferous objections of the Committee and other unsecured creditors.[4] While the bankruptcy court agreed to enter

[3] The amended order specifically included a "finding" by the bankruptcy court that *all* of the debtors had received "a reasonably equivalent value" in exchange for the grant of prepetition security interests to the banks (App. 37a-38a).

[4] Almost a year after these bankruptcy petitions were filed, it was becoming clear that no successful reorganization of these debtors would occur and

the amended order, the court stated on the record that it was unsure of whether it had the authority to take away the unsecured creditors' right to challenge the banks' prepetition security interests and suggested an appeal to resolve the issue.[5]

The Committee and Mobil appealed the amended order to the District Court for the Western District of Michigan, Northern Division ("district court"), asserting, *inter alia*, that the amended order contains numerous significant "findings" of fact by the bankruptcy court that were not supported by *any* evidence presented at the hearing or otherwise and thus are clearly erroneous,[6] that banks' prepetition liens were conclusively established without a proper "adversary proceeding"

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that a liquidation of these debtors, which had already begun informally, was inevitable. Indeed, at the emergency hearing on the Petition, the chief financial officer of the debtors testified that he was not sure a successful reorganization was possible and that the continued operations of these debtors as going concerns included the use of proceeds from the continuing sale of "hard assets," as opposed to product, of these debtors. Transcript - Telephonic Hearing, Bankruptcy Court, December 21, 1984, at 22, 41-42. Thus, the amended order would provide for minimal additional financing that might briefly forestall the inevitable liquidation of these debtors while effectively denying the unsecured creditors any recovery on their claims in a liquidation by precluding an opportunity to set aside the banks' prepetition security interests in the assets of these debtors.

[5] Transcript - Telephonic Hearing, Bankruptcy Court, dated December 21, 1984, at 69-70.

[6] For example, as noted *supra* note 3, p. 5, the amended order specifically included a "finding" by the bankruptcy court that all of the debtors had received "a reasonably equivalent value" in exchange for the grant of prepetition security interests to the banks (App. 37a-38a) when there was no evidence presented at the hearing on this issue upon which the bankruptcy court could make such a finding. As another example, the amended order provided that the bankruptcy court found that there was "little likelihood" that the fraudulent conveyance objections to the security interests would be sustained (App. 34a) when the record of the hearing shows that there was no evidence presented to support such a finding and when the bankruptcy court, in an opinion dated two days before the hearing, had implicitly recognized the merits of the fraudulent conveyance challenge in denying substantive consolidation because of the "great" prejudice to the unsecured creditors in denying them the right to make the challenge (App. 44a).

required by Bankruptcy Rule 7001 to "determine the validity, priority, or extent of a lien or other interest in property" and thus constituted an unconstitutional taking of property without due process of law, and that the amended order violates the provisions of the Bankruptcy Code, including §364(c).

In response to a motion made by Northern Trust, the district court dismissed the appeal as moot pursuant to §364(e). The court below upheld the district court's dismissal of the appeal. The opinion of the court below and the concurring opinion held that §364(e) protects all of the provisions of the amended order from appellate review. The dissenting opinion held that §364(e) "is not designed to cut off the right to appeal rulings on *prepetition* matters, such as fraudulent conveyances and preferences, but only affects authorized postpetition loans and liens to secure such loans" (emphasis in original). 834 F.2d at 607 (App. 15a-16a).

REASONS FOR GRANTING THE WRIT

I. THE FEDERAL COURT OF APPEALS HAS DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT.

This Court should grant this petition because the decision below is overly broad in its application of a narrow provision of federal law that will result in significant harm to the bankruptcy system in allowing secured creditors to be improperly preferred over unsecured creditors with respect to prepetition debt, because the decision below mandates that the underlying important federal question here, though frequently recurring, will remain without review, and because the decision denies the unsecured creditors due process under the law.

A. The Decision of the Court Below Unreasonably Expands the Application of the Protections of §364(e) to Provisions That Are Beyond the Scope of §364.

The decision of the court below unreasonably expands the application of the protections of §364(e) to provisions of the

amended order which are beyond the scope of §364.[7] The expansion of the limited protections of §364(e) to all provisions of the amended order is inherently inequitable to all unsecured creditors here, contrary to the fundamental principle of equality that is the foundation of bankruptcy law. Furthermore, the decision of the court below establishes a broad precedent that allows for future inequitable treatment.

Section 364 of the Bankruptcy Code, entitled Obtaining Credit, provides for the various postpetition financing procedures available in bankruptcy. Section 364(c), the subsection that applies to *some* parts of the amended order here, authorizes a Chapter 11 debtor[8] to obtain postpetition financing whereby the lender is given certain priorities or granted liens on property of the estate to secure the financing. Section 364(e) provides limited protection to debts incurred and priorities or liens granted *under* §364. The statute provides:

> (e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt or the granting of such priority or lien, were stayed pending appeal.

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[7] The challenged provisions of the amended order authorize a practice euphemistically referred to as "cross-collateralization". Cross-collateralization means that in return for extending new, postpetition credit to a debtor, the lender obtains a security interest in all assets of the debtor to secure the new loans *and* the debtor's existing, prepetition indebtedness to the lender. *See Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)* 596 F. 2d 1092, 1094 (2d Cir. 1979). Here, the amended order, in addition to granting the banks super-priority liens to secure the financing authorized therein, conclusively establishes the banks' *prepetition* security interests and precludes a fraudulent conveyance challenge to these *prepetition* interests.

[8] All references to a "trustee" in this section apply equally to a "debtor in possession" in a chapter 11 case. 11 U.S.C. §1107(a).

The Committee acknowledges that the priorities and liens granted in the amended order securing the credit advanced by the banks pursuant to that order are protected from reversal or modification on appeal as a stay of the order pending appeal was not obtained.[9] *However, because the cross-collateralization provisions of the order are not allowed under §364, the protections of §364(e) do not apply and the failure to obtain a stay of the order does not render moot the appeal of the cross-collateralization provisions of the order.*

Cross-collateralization is not provided for within the specific terms of the provisions of §364. Moreover, the legislative history of section 364 indicates that Congress intended section 364 to contain the *exclusive* list of allowable financing arrangements.

> The legislative history of section 364 supports the argument in favor of exclusivity. The House and Senate Reports contain the following identical language with regard to section 364: "This section is derived from provisions in current law governing certificates of indebtedness, but is much broader. *It governs all obtaining of credit and incurring of debt by the estate.*" This language certainly can be interpreted to mean what it says; i.e., section 364 governs all methods of obtaining financing by the estate. Exclusivity is simply the negative formulation of that statement—that there are no methods of obtaining financing which are not covered by section 364.
>
> The detailed and comprehensive nature of section 364, and the historical antecedents of the respective subsections of section 364, strengthens the argument for exclu-

[9] Although the Committee is asserting that the priorities and liens granted securing the credit advanced pursuant to the amended order are invalid because the banks did not extend the credit in good faith, *see infra* p. 25, at all levels of this appeal the Committee has acknowledged that, if the banks are deemed to have advanced the postpetition credit in good faith, the priorities and liens granted to the banks are protected from reversal on appeal. It should be noted that the Committee did seek a stay of the amended order for other reasons after the order was entered and its request was denied.

> sivity. A consideration of these matters shows that section 364 specifically authorizes and states the prerequisites for granting every type of inducement to a prospective lender to the bankruptcy estate—whether a lien, priority, or both—that was accepted and approved generally under the Act. The comprehensive treatment of financing in section 364 suggests, both as a matter of logic and as an accepted principle of statutory construction, that section 364 contains the exclusive list of acceptable inducements to prospective lenders. (citations omitted) (emphasis in original).

Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy,* 60 S. Cal. L. Rev. 109, 120-121, nn. 72-73.[10] Indeed, Congress was not even aware of cross-collateralization when it enacted the Bankruptcy Code. *See infra* p. 22. As cross-collateralization cannot be authorized under §364, §364(e) cannot apply to bar appellate review of the cross-collateralization provisions of the amended order for failure to obtain stay of the order.

By unreasonably expanding the protections of §364(e) to all provisions of the amended order, the decision of the court below imposes a severe hardship on all unsecured creditors of these related cases. By the amended order, the banks' security interests securing $4,000,000 in prepetition debt are protected from any fraudulent conveyance challenge in exchange for the banks having advanced merely $60,000 postpetition. By applying the protections of §364(e) to the cross-collateralization provisions of the amended order, the court below has taken away from the unsecured creditors the only "asset" they have in that if the banks' prepetition security interests are not defeasible by

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[10] In his article, published after the Committee's brief had been submitted to the Court of Appeals below, Professor Tabb engages in the most exhaustive and comprehensive analysis of cross-collateralization in bankruptcy by any commentator to date. After reviewing the history of financing in bankruptcy and analyzing the arguments in favor of the practice, Professor Tabb concludes that cross-collateralization should never be allowed in bankruptcy financing for numerous reasons, some of which will be discussed herein. The persuasive arguments of Professor Tabb support the Committee's arguments against cross-collateralization it has asserted in the underlying appeal of the amended order to the district court.

reason of a fraudulent conveyance challenge or otherwise, $4,000,000 worth of debt, worth more than all of the assets of the debtors, will be applied against those assets, leaving the unsecured creditors with no assets to satisfy their claims. Such preferential treatment is obviously contrary to the fundamental principle of equality that forms the basis of bankruptcy law.

> This central principle of equality, recognized consistently by the Supreme Court from the passage of the first true Bankruptcy Act in 1841 to modern times, is manifested throughout the Bankruptcy Code. Equal treatment of similarly situated creditors is mandated in the bankruptcy distribution scheme, both in Chapter 7 liquidations and in rehabilitations under Chapter 11 and Chapter 13. This policy is further implemented by provisions authorizing the avoidance of transfers to creditors in contravention of the equality rule, and by automatically preventing such a transfer from occurring in the first place. Further, creditors are not permitted to gain favored treatment of prepetition claims by utilizing leverage postpetition against the estate.

Tabb, 60 S. Cal. L. Rev. 109, 145-146, nn. 186-191, citing, *Shawhan v Wherritt,* 48 U.S. (7 How.) 328, 331-332 (1848); *Nathanson v. NLRB,* 344 U.S. 25, 29 (1952); (additional citations omitted).

In addition to unfairly depriving the unsecured creditors in these cases of their right to challenge the banks' prepetition security interests, the decision of the court below establishes a broad precedent that will allow for future abuses of creditors by others. Pursuant to the decision of the court below, any secured creditor whose prepetition security interest is incomplete, defective or otherwise subject to challenge could seek to have the bankruptcy court enter a comprehensive order that includes minimal postpetition financing and that "cures" any problems, and could become completely protected from appellate review of all provisions of that order, including the cross-collateralization provisions, merely by advancing minimal funds pursuant to the order. With the entry of such a comprehensive order and the advancement of funds pursuant to the order, the secured creditor's prepetition security interest would be com-

pletely protected from challenge or appellate review no matter how improper or illegal the terms of the order, no matter how obviously incomplete or defective the secured creditor's claimed prepetition security interest, no matter how unsupported and baseless the "findings" supporting the order, no matter how extensive the secured creditor's claimed prepetition security interest and how large its prepetition debt, and no matter how minimal the secured creditor's postpetition financing. Such a broad precedent will facilitate future abuse of unsecured creditors by others.[11]

The decision of the court below unreasonably expands the application of §364(c) and thus, §364(e), to include all provisions of the amended order. This results in patently inequitable treatment of the unsecured creditors here, and establishes a broad precedent that allows for future preferential treatment by some creditors over others. This Court should grant this petition to clarify whether Congress intended such a result.

B. The Decision of the Court Below Precludes Review of An Important Question of Federal Law Which Has Not Been, But Should Be, Settled By This Court

The decision of the court below establishes a precedent

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[11] The concurring opinion of the court below was written separately, in part, "to emphasize the limited precedential effect of our holding in this case . . . . "834 F.2d at 605-606 (App. 12a). Apparently, the concurring opinion believes that the particular facts of this case will limit the application of that court's decision. However, the facts of this case upon which the concurring opinion relies are those *stated in the amended order*. Attempting to limit the precedential scope of the court's decision by emphasizing the particular "facts" of this case as provided for in the amended order completely overlooks the nature of the underlying appeal below. *The Committee is challenging the amended order on appeal precisely because it contains "findings" of fact which are completely baseless and are contrary to the true facts. See supra* note 6, p. 6. Furthermore, reliance on the provisions of the amended order will not limit the precedential effect of this decision but rather will encourage future similar abuse, as any secured creditor seeking to evade a challenge to its secured status can do exactly what the banks did here, merely draft a comprehensive order with extensive but baseless "findings" of fact in support of the order and insist that the bankruptcy court enter that particular order before it will make any further financing.

that will effectively preclude review by appellate courts of another important question of federal law which has not been settled by this Court or by any federal appellate court. The primary issue in the underlying appeal here is whether the Bankruptcy Code allows the use of "cross-collateralization" financing orders. Cross-collateralization financing is a controversial aspect of bankruptcy procedure that is being used more often by bankruptcy courts despite the fact that neither this Court nor a federal appeals court has definitively ruled on the propriety of such financing in bankruptcy. Indeed, the one federal appeals court decision that serves as the only legal authority for the bankruptcy court decisions authorizing cross-collateralization strongly suggests that cross-collateralization financing in bankruptcy is improper.

In *Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)*, 596 F. 2d 1029 (2d Cir. 1979), the court upheld a challenge to the entry of a cross-collateralization financing order that had been entered on an *ex parte* basis the same day the debtor filed a petition for arrangement under Chapter XI of the former Bankruptcy Act of 1898 ("Bankruptcy Act"), the predecessor to the current Bankruptcy Code. In analyzing the propriety of cross-collateralization in bankruptcy, the court considered both the Bankruptcy Act and the then recently-enacted Bankruptcy Code, stating as follows:

> The bankruptcy judge and the district judge were nevertheless correct in concluding that the *ex parte* financing order was unauthorized insofar as it granted [the secured creditor] additional security for the prepetition debt in consideration for its entering into the factoring agreement in making $100,000.00 in advances. Any such arrangement made by the bankrupt while insolvent and within four months before the filing of a petition would have constituted a voidable preference . . . . We have been pointed to no appellate decision in the long history of reorganization under §77, former §77B, Chapter X and Chapter XI of the Bankruptcy Act, that has sustained an order authorizing action by a receiver, trustee or a person with equivalent powers which, if done by the debtor, "would be a fraud on the act, as it would work an unequal distribution of the

bankrupt's property." *Tiffany vs. Boatman's Institution*, 18 Wall. (85 U.S.) 375, 388, 21 L.E. d 868 (1873). While §367(6) [of the Act] permits a Chapter XI arrangement to contain "provisions for payment of debts incurred after the filing of the petition and during the pendency of the arrangement, in priority over the debts affected by such arrangement," nothing in that section suggests that different treatment for prepetition debts of the same class is permissible . . . .

. . . .

. . . To such limited extent as it is proper to consider the new Bankruptcy Act, [the current Bankruptcy Code], which takes effect on October 1, 1979, in considering the validity of an order made in 1974 . . . we see nothing in §364(c) or in the other provisions of that section that advances the case in favor of "cross-collateralization". In order to decide this case we are not obliged, however, to say that under no conceivable circumstances could "cross-collateralization" be authorized. Here it suffices to hold that, despite the absence from §344 of the specific requirement of notice contained in §116(2), . . . a financing scheme so contrary to the spirit of the Bankruptcy Act should not have been granted by an *ex parte* order, where the bankruptcy court relies solely on representations by a debtor in possession that credit essential to the maintenance of operations is not otherwise obtainable. (citations omitted).

596 F.2d at 1097-1099.

Strangely, the opinion of the court in *Texlon* has served as the *sole* legal basis of authority for bankruptcy courts to authorize cross-collateralization. Completely overlooking the extensive analysis by the court in *Texlon* and that court's conclusion that there is nothing in the former Bankruptcy Act or the current Bankruptcy Code that allows "a financing scheme so contrary to the spirit" of bankruptcy law, these courts have used the *Texlon* court's statement, in dicta, that it could not say that under "no conceivable circumstances" could cross-collateralization be authorized to allow the use of this type of financing. *See, e.g., In re General Oil Distributors, Inc.*, 20 Bankr. 873 (Bankr. E.D.

N.Y. 1982); *In re Vanguard Diversified, Inc.*, 31 Bankr. 364 (Bankr. E.D. N.Y. 1983); *In re B & W Tractor Co., Inc.*, 38 Bankr. 613 (Bankr. E.D. N.C. 1984); *In re Beker Industries Corp.*, 58 Bankr. 725 (Bankr. S.D. N.Y. 1986). *See also*, Weintraub & Resnick, *Cross-collateralization of Prepetition Indebtedness as an Inducement for Postpetition Financing: A Euphemism Comes of Age*, 14 U.C.C.L.J. 86 (1981); Bohm, *The Legal Justification for the Proper Use of Cross-Collateralization Clauses in Chapter 11 Bankruptcy Cases*, 59 Am. Bankr. L. J. 289 (1985).

Despite the well-supported assertions of the impropriety of cross-collateralization in bankruptcy, both by commentators[12] and the only federal appeals court to analyze the history of financing in bankruptcy, bankruptcy courts continue to authorize cross-collateralization despite objections by aggrieved parties. Moreover, appellate courts, faced with dismissal motions under §364(e), have sanctioned these improper authorizations by dismissing the appeals of the orders for the failure to obtain a stay.

By expanding the scope of §364, and thus the protections of §364(e), to include the cross-collateralization provisions of the amended order, the decision of the court below conclusively establishes the propriety of the cross-collateralization provisions of the amended order here and serves to preclude appellate review of other cross-collateralization financing orders that may be entered under similar circumstances. The court below acknowledges that the amended order goes beyond the permissible financing arrangements allowed pursuant to §364 but nevertheless spreads the protection of §364(e) to cover provisions outside of §364.

> This order in controversy bolstered liens securing prepetition debt, and thus may exceed the scope of section 364(c).
>
> . . . If an order exceeded the scope of section 364(c), is it not entitled to section 364(e) protection, if purportedly

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[12] *See* Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. Cal. L. Rev. 109 (1987), discussed *supra* note 10, p. 10. *See also*, Comment, *Initial Financing Restrictions in Chapter XI Bankruptcy Proceedings*, 78 Colum. L. Rev. 1683 (1978).

> granted under section 364(c) and relied on by the debtor and lending party in good faith?"

834 F.2d at 602 (App. 5a-6a).

The analysis of the court below is flawed as it approaches the issue from the wrong direction. Section 364(e) protects the financing arrangements allowed under §364.[13] If the financing arrangement is not allowed under §364, then the protections of §364(e) cannot apply. Indeed, why would Congress intend to defer completely to the bankruptcy courts and limit appellate review of the propriety of financing schemes it has not authorized.[14]

That improperly expanding the protections of §364(e) to cross-collateralization provisions only exacerbates the problem of precluding appellate review of the propriety of cross-collateralization in bankruptcy is demonstrated by the recent decision of the Ninth Circuit Court of Appeals in *Burchinal v. Central Washington Bank (In re Adams Apple)*, 829 F.2d 1484 (9th Cir. 1987). In *Adams Apple*, the court dismissed as moot under §364(e) an appeal of a cross-collateralization financing order because the order was not stayed pending appeal. However, the court noted that its holding was limited to the question of mootness and not the question of the propriety of cross-collateralization in bankruptcy.

> Our conclusion that cross-collateralization clauses are "authorized" under section 364 is limited to the context of 364(e) mootness, and is not intended to prevent a future panel from holding, if it so determines, that cross-collateralization is illegal per se. Because the bankruptcy judge thought that cross-collateralization was legal and entered an order to that effect upon which the creditor

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[13] See discussion *supra* pp. 8-10.

[14] The concurring opinion below also chooses to defer to the bankruptcy court's own determination of what it can do. ". . . given the particular circumstances of this case I cannot say that the bankruptcy court was completely unreasonable in construing the scope of its authority as broadly as it did." 834 F.2d at 606 (Nelson, J., concurring) (App. 14a).

> relied, we conclude that the creditor should receive the protection of section §364(e) in this case.

829 F.2d at 1489 n. 6. The *only* legal authority the court cited in support of its application of §364(e) to the cross-collateralization clauses is the District Court decision in this case below. *See* 829 F.2d at 1488-1489 citing *Unsecured Creditors' Committee v. First National Bank & Trust Co. of Escanaba (In re Ellingsen MacLean Oil Co., Inc.)*, 65 Bankr. 358 (W.D. Mich. 1986).

Like the rationale of the court below, the reasoning of the court in *Adams Apple* is backward. Despite acknowledging the probable impropriety of cross-collateralization, the court uses the application of §364(e) to improperly defer to the bankruptcy court's decision to allow cross-collateralization. *Thus, expanding the application of the protections of §364(e) to cross-collateralization provisions precludes a conclusive determination of whether cross-collateralization financing is authorized in bankruptcy!*

By expanding the protection of §364(e) to the cross-collateralization provisions of financing orders the question of whether cross-collateralization is allowed under the Bankruptcy Code will not be resolved.[15] Instead, bankruptcy courts will acquiese to prepetition lenders' demands for cross-

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[15] Arguably an appeals court might not feel obligated to dismiss the appeal as in *Adams Apple*, and might hear the merits of the appeal, if a stay of the financing order is obtained. However, it is unlikely aggrieved parties will be able to obtain a stay. The precarious and volatile nature of a bankrupt debtors' finances regularly requires the need for sudden bankruptcy court authorization for immediate secured financing. The attendant exigent circumstances surrounding the debtor's need for immediate credit suggests that the bankruptcy court that has just granted the debtor's request will be unlikely to stay the entry of the financing order immediately after deciding that the financing is needed. Furthermore, as the financing authorized by the bankruptcy court's order will by necessity take place immediately, the likelihood of getting another court to review the propriety of the bankruptcy court's denial of the stay before the additional funds are advanced to and applied by the debtor is minimal. Because a stay is not retroactive and does not invalidate what was done before the stay, 7 J. Moore, B. Ward, J.D. Lucas, Moore's Federal Practice, ¶ 62.06 (2d ed. 1987), the stay must be obtained before the authorized lending takes place.

collateralization before agreeing to finance debtors and aggrieved parties will be unable to effectively oppose cross-collateralization despite the probability that it is "illegal per se". This Court should grant this petition to resolve this important question of federal law.

C. The Decision of the Court Below Results in a Denial of Due Process of Law

Applying the protections of §364(e) to the cross-collateralization provisions of the amended order here results in a denial of due process of law to the unsecured creditors of these debtors and establishes a precedent for future denials for creditors in similar situations.

The Due Process Clause of the Fifth Amendment to the United States Constitution requires at a minimum "that deprivation of life, liberty, or property by adjudication be preceded by notice and opportunity for hearing appropriate to the nature of the case." *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1949). "The purpose of notice under the Due Process Clause is to apprise the affected individual of, and permit adequate preparation for, an impending hearing." *Memphis Light, Gas & Water Division v. Craft*, 436 U.S. 1, 14 (1977). Furthermore, "the bankruptcy power is subject to the Fifth Amendment." *United States v. Security Industrial Bank*, 459 U.S. 70, 75 (1982). Also, unsecured creditors are entitled to procedural due process. *Reliable Electric Co., Inc. v. Olson Construction Co.* 726 F.2d 620, 623 (10th Cir. 1984).

Here, the Committee and other creditors challenging the entry of the amended order were not given the opportunity to adequately challenge the validity of the banks' prepetition liens prior to the bankruptcy court conclusively establishing the liens by the entry of the amended order. The emergency hearing held by telephone with one day's advance notice did not permit adequate preparation for the hearing, thereby precluding the unsecured creditors from having any meaningful opportunity to be heard on this issue. As a result, the unsecured creditors were

deprived of their property in violation of the Due Process Clause of the Fifth Amendment to the United States Constitution.

Apart from the denial of a meaningful opportunity to be heard, by applying the notice and hearing requirements of §364(c) to the right to challenge the banks' prepetition security interests, the unsecured creditors have been denied the opportunity to challenge these prepetition liens in the same manner available to other similarly situated parties.

Bankruptcy Rule 7001(2) provides for an adversary proceeding "to determine the validity, priority, or extent of a lien or other interest in property." (App. 47a). As the Advisory Committee Note to the Rule states, "[t]he rules in Part VII [Adversary Proceedings] govern the procedural aspects of *litigation* involving the matters referred to in the Rule 7001." (emphasis added). Thus, the rules provide for litigation by way of an adversary proceeding to determine the "validity, priority or extent" of a lien or an interest in property. Here, by expanding the scope of §364, and thus the protections of §364(e), to the cross-collateralization provisions of the amended order, these unsecured creditors are unilaterally denied their opportunity to litigate the issue of the validity of the banks' prepetition security interests and to attempt to set aside these security interests as fraudulent conveyances pursuant to §548 of the Bankruptcy Code.

Furthermore, the clear opportunity to litigate this issue as provided for in Bankruptcy Rule 7001(2) demonstrates that §364, and thus §364(e), were not meant to apply to the cross-collateralization provisions of the amended order. While the notice and hearing requirements of §364(c) may be altered to exigent circumstances,[16] Bankruptcy Rule 7001 does not allow for any waiver of the requisite adversary proceeding. Also, Bankruptcy Rule 7001 does not list *postpetition* financing orders as being included within its scope. Thus, the fact that §364 and Bankruptcy Rule 7001 provide separate and distinct

[16] Section 102(1) of the Bankruptcy Code, indicates that "after notice and a hearing" means after such notice and such opportunity for a hearing "as is appropriate in the particular circumstances." 11 U.S.C. §102(1).

requirements regarding the proper extent of the hearing required demonstrates that §364 was meant to apply only to authorizations of postpetition financing and liens and priorities securing the postpetition financing, and not to the cross-collateralization provisions that concern liens given to secure *prepetition* financing. Indeed, the apparent conflict between the notice and hearing requirements found in Bankruptcy Rule 7001 and §364 can be reconciled by the interpretation of §364 asserted by the Committee. If the protections of §364(e) are limited to the liens and priorities granted to secure financing authorized under §364, that is, court-authorized, postpetition financing, Bankruptcy Rule 7001 will still be operative here. While the super-priority liens granted to secure the *postpetition* financing authorized by the amended order will be protected from reversal on appeal because no stay of the order was obtained, the unsecured creditors will still be given the right to litigate the fraudulent conveyance challenge to the security interests securing the banks' *prepetition* indebtedness.

This Court should grant this petition to consider these important questions of law.

II. THE FEDERAL COURT OF APPEALS BELOW HAS DECIDED A FEDERAL QUESTION IN A WAY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

A. The Decision of the Court Below Conflicts With Decisions of This Court Regarding Basic Statutory Construction

The decision of the court below extending the protections of §364(e) to all provisions of an order that includes cross-collateralization financing conflicts with numerous established principles of basic statutory construction established by this Court. Indeed, had the court below followed the clear dictates of this Court, it would have limited the application of §364(e) to

only those liens and priorities properly granted under §364 to secure the postpetition financing authorized in the amended order.

"As in every case involving the interpretation of a statute, analysis must begin with the language employed by Congress." *Howe v. Smith,* 452 U.S. 473, 480 (1981). "Absent clear evidence of a contrary legislative intention, a statute should be interpreted according to its plain language." *United States v. Apfelbaum,* 445 U.S. 115, 121 (1980). "Absent a clearly expressed legislative intention to the contrary, the language of the statute must ordinarily be regarded as conclusive." *United States v. Turkette,* 452 U.S. 576, 580 (1981).

The decision of the court below acknowledges that "[t]he express language of [§364(c)] suggests that the priority or lien granted thereunder is limited to securing the newly incurred debt authorized by [§364(c)]." 834 F.2d at 601 (App. 4a). Yet, the court below ignores the fact that §364(e) by its own, unambiguous terms protects from appellate review an "authorization *under this section* to obtain credit or incur debt, or of a grant *under this section* of a priority or a lien." (emphasis added). Since the plain language of §364(e) limits its protection to liens granted "under this section," that is, under §364, and since the "express language" of §364(c) limits the liens granted thereunder to securing newly incurred debt, §364(e) cannot apply to protect from appellate review those provisions of the amended order precluding a fraudulent conveyance challenge to the banks' *prepetition* security interests. In deciding otherwise,the decision of the court below fails to follow the decisions of this Court.

Furthermore, in ignoring the plain language of §364, the court below does not rely on any indications of any contrary intention of Congress as found in the legislative history. Indeed, as discussed *supra* p. 9, the legislative history of §364 indicates that Congress intended §364 to contain an exclusive list of permissible financing procedures. As §364 is exclusive in listing permissible financing arrangements, cross-collateralization is not allowed thereunder and the protections of 364(e) cannot preclude appellate review of the propriety of cross-collateralization financing in bankruptcy.

In addition, the court below should have construed §364 as it was intended to be construed at the time it was passed. *Platt v. Union Pacific Railroad Co.*, 99 U.S. 48, 60 (1878) ("All will concede that in construing the act of 1862 we are to look at the state of things then existing, and in the light then appearing seek for the purposes and objects of Congress in using the language it did."). Here, it appears Congress was not even aware of the use of cross-collateralization when it enacted the Bankruptcy Code.

> No mention of the practice is made anywhere in the committee reports, the joint legislative statement, the earlier floor debates, the Commission Report, or any of the hearings dealing with the obtaining of credit. Considering the lengthy debate and deliberation leading up to the passage of the Bankruptcy Reform Act of 1978, this omission is quite understandable, since cross-collateralization had not surfaced as an issue at the time the Code was passed in the fall of 1978.

Tabb, 60 S. Cal. L. Rev. at 134-135. As indicated *infra* pp. 13-14, the initial legal authority used to justify the authorization of cross-collateralization by some bankruptcy courts is the decision by the Second Circuit in *Texlon* decided well after the enactment of the Bankruptcy Code.

By ignoring the plain language of §364 and the lack of any evidenced intention of Congress to include cross-collateralization provisions within §364, the decision of the court below effectively amends the statute which it should not do. *Matson Navigation Co. v. United States*, 284 U.S. 352, 356 (1931) ("As the words of the section are plain, we are not at liberty to add to or alter them to effect a purpose which does not appear on its face or from its legislative history."). This Court should grant this petition to resolve these conflicts with the applicable decisions of this Court.

B. The Decision of the Court Below is in Conflict With this Court's Protective Committee *Decision*

The amended order entered by the bankruptcy court below provides that "[t]he Debtors in Possession have agreed to settle all controversies regarding the validity of the Banks' security interests, liens and encumbrances by waiving any objections they may have with respect thereto, including without limitation that guarantees of one Debtor's Liabilities by another Debtor were not given in exchange for reasonably equivalent value . . . ." (App. 34a). However, this settlement was forced upon the unsecured creditors by the entry of the amended order and the application of the protections of §364(e) to these provisions of the amended order negates the effect of this Court's decision in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson,* 390 U.S. 414, (1968) *reh denied,* 391 U.S. 909 (1968).

In *Protective Committee,* this Court established the difficult test for the settlement of causes of action in bankruptcy. In that case, the trustee had reported that the certain causes of action had merit only to subsequently recommend that the causes of action be settled. In rejecting the settlement, this Court found that the decisions of the lower courts in approving the settlements did not meet the high standards required.

> At the same time, however, it is essential that every important determination in a reorganization proceedings receive the 'informed independent judgment' of the bankruptcy court . . . . There can be no informed and independent judgment as to whether a proposed compromise is fair and equitable until the bankruptcy judge has apprised himself of all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all

> other factors relevant to a full and fair assessment of the wisdom of the proposed compromise. Basic to this process in *every instance,* of course, is the need to compare the terms of the compromise with the likely rewards of litigation." (citations omitted) (emphasis added).

390 U.S. at 424 - 425. This Court strongly criticized the lower courts for the failure to distinguish between "a comprehensive consideration of all relevant factors, and mere boiler plate approval phrased in appropriate language but unsupported by evaluation of the facts or analysis of the law," and for basing their approval of the settlement on a "bare statement of conclusions". 390 U.S. at 434, 433.

By applying the protections of §364(e) to all provisions of the amended order, including those whereby the debtors agreed to settle all controversies regarding the banks' *prepetition* liens and security interests by specifically waiving the right to challenge these banks' liens and security interests on fraudulent conveyance grounds, the decision of the court below conflicts with this Court's decision in *Protective Committee*. This conflict is all the more critical here as the abuses this Court was trying to remedy in *Protective Committee* are identical to the abuse this settlement represents in this case.[17]

Neither the plain language of §364(e) nor its legislative history reveal any intention of Congress to alter the strict standards of *Protective Committee*. Thus, extending the protections of §364(e) to all provisions of the amended order further conflicts with another applicable decision of this Court. "The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created

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[17] The facts of this case are virtually on all fours with the facts in *Protective Committee*. There the Trustee, as did the bankruptcy court below, had earlier concluded that there were potential grounds for the causes of action. There, as here, the cause of action was later compromised. There, as here, no new evidence was presented upon which this reversal was based, only "boiler plate approval phrased in appropriate language." 390 U.S. at 434.

concept, it makes that intent specific. . . . The Court has followed this rule with particular care in construing the scope of bankruptcy codifications." *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494, 501 (1986).

III. The Federal Court of Appeals Below Has Rendered a Decision in Conflict With Decisions of Other Federal Courts of Appeal on the Same Matter.

The decision of the court below represents a conflict among the federal courts of appeal on the question of what constitutes good faith under §364(e) and what procedure is to be followed in addressing this issue.

Neither the Bankruptcy Code nor the Bankruptcy Rules define "good faith". Thus, various courts, in applying §364(e) and its analog 363(m)[18], have attempted to fashion an applicable good faith standard and have come up with varying standards of "good faith". *See Burchinal v. Central Washington Bank (In re Adams Apple, Inc.)* 829 F.2d 1484, 1489 (1987), and cases

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[18] Section 363(m) provides:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not effect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal. 11 U.S.C. §363(m).

Section 363(m) provides the same limited protection to purchasers of a debtor's property that is provided to postpetition lenders. *See* H. Rep. No. 595, 95th Cong., 1st Sess. 346-347 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 57-58 (1978).

It should be noted that a petition for writ of certioriari has been filed with this Court concerning the scope of §363(m). *See Cargill, Inc. v. Charter International Oil Co.*, 829 F.2d 1054 (11th Cir. 1987), No. 87-1401.

cited therein. This conflict among the federal courts of appeal is evidenced by the application of the standards of two different cases to the facts of the case here.

In *In re EDC Holding Co.*, 676 F.2d 945, 947 (7th Cir. 1982) the Court of Appeals for the Seventh Circuit discussed the good faith requirements of §364(e) as follows:

> And while it is clear as we have said that knowledge that there are objections to the transaction is not enough to constitute bad faith, we can find neither cases nor legislative history, pertaining either to good faith lenders to bankrupts or to good faith purchasers from bankrupts, that tell us what is enough. [The lender] argues that so long as the terms of the transaction are not misrepresented to the bankruptcy judge, as they were not here, the creditor may rely on the bankruptcy judge's order unless it is stayed, no matter how obviously erroneous the order is. But if this is what Congress intended, the words "in good faith" could have been deleted, as it would be perfectly clear even without them that an order obtained from a bankruptcy judge by fraud was ineffective to put the lender who procured the order ahead of other creditors. We assume the statute was intended to protect not the lender who seeks to take advantage of a lapse in oversight by the bankruptcy judge but the lender who believes his priority is valid but cannot be certain that it is, because of objections that might be upheld on appeal. If the lender knows his priority is invalid but proceeds anyway in the hope that at stay will not be sought or if sought will not be granted, we cannot see how he can be thought to be acting in good faith. . . . (citations omitted).

The decision of the court below relied upon *EDC* in rejecting the assertion that the banks had not acted in good faith here. "The statute was intended to protect 'the lender who believes his priority is valid but cannot be certain that it is, because of objections that might be upheld on appeal'." 834 F.2d at 605, quoting, *EDC*, 676 F.2d at 947.

However, in *In re Abbotts Dairies of Pennsylvania, Inc.*, 788 F.2d 143 (3rd Cir. 1986), the Court of Appeals for the Third Circuit suggests other factors as determinative of good faith under §363(m):

> The requirement that a purchaser act in good faith . . . speaks to the integrity of his conduct in the course of the sale proceedings. Typically, the misconduct that would destroy a purchaser's good faith status at a judicial sale involves fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders.

In remanding the matter back to the bankruptcy court for findings of fact on the question of good faith, the court reasoned that if the objecting creditors could substantiate their allegations that the timing of the debtors' bankruptcy was manipulated so that the bankruptcy court had no choice but to approve the challenged order, the terms of which were designed to preclude any truly competitive bidding for the assets sold, it would as a matter of law constitute "collusion . . . or an attempt to take grossly unfair advantage of other bidders," sufficient to destroy the creditor's good faith status. 788 F.2d at 148.

In this case, the Committee is asserting on appeal that the banks precipated the emergency nature of the hearing on the amended order thereby forcing the bankruptcy court to reluctantly enter the order, the terms of which unilaterally take away the right to challenge the banks' prepetition security interests on fraudulent conveyance grounds. Under the standards of *Abbotts Diaries*, if these allegations were substantiated, it would constitute "collusion . . . or an attempt to take grossly unfair advantage" of other creditors, sufficient to destroy the banks' good faith status.

Thus, the application of the *EDC* principles by the court below appears to preclude a finding of lack of good faith while the application of the *Abbotts Dairies* standard arguably supports a finding of lack of good faith by the banks. This Court should grant this petition to resolve this conflict.

In addition to conflicting standards of what constitutes good faith, the federal appellate courts appear to be split over how a

determination of good faith will be made. The court below states that"[b]oth the bankruptcy court and the district court found that the Banks had acted in good faith. . . ." 834 F.2d at 605 (App. 11a). However, there is no evidence in the record of any such finding by the bankruptcy court and even the amended order, although comprehensive in its protection of the banks, contains no such finding. Presumably, the court below concluded that the bankruptcy court *implicitly* made such a finding of good faith in that it would not have entered the amended order if it concluded otherwise. However, in *In re Abbotts Dairies*, the court held that the bankruptcy court must make explicit findings on the question of a good faith purchaser and that an appeal from a bankruptcy court's approval of a sale is not moot if the bankruptcy court did not conclusively determine the purchaser was a good faith purchaser. Application of the holding of *Abbotts Dairies* here requires that this matter be remanded to the bankruptcy court for findings of fact on this issue.

This Court should grant this petition to resolve these conflicts among the federal appellate courts.

CONCLUSION

The court below has improperly extended the application of the protections of 11 U.S.C. §364(e) to provisions of bankruptcy court orders outside of the scope of §364. This error means that secured creditors will be improperly preferred over unsecured creditors, that the underlying issue, namely the propriety of cross-collateralization in bankruptcy, though recurring, will remain without appellate review, and that the unsecured creditors will be denied due process of law. Therefore, this case presents important and recurring questions of bankruptcy practice that, in the interest of the policies behind the Bankruptcy Code, merit this Court's attention and clarification.

The petition for a writ of certiorari should be granted.

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April, 1988

APPENDIX

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No. 86-1452
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

In Re: ELLINGSEN MacLEAN OIL CO., INC., and related cases,

Debtor.

UNSECURED CREDITORS' COMMITTEE; MOBIL OIL CORPORATION,

Plaintiffs-Appellants.

v.

FIRST NATIONAL BANK & TRUST COMPANY OF ESCANABA, and THE NORTHERN TRUST COMPANY,

Defendants-Appellees.

ON APPEAL from the United States District Court for the Western District of Michigan

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Decided and Filed November 30, 1987

Before MERRITT, WELLFORD and NELSON, Circuit Judges.

WELLFORD, Circuit Judge

This case presents interesting and difficult questions about the application of section 364 of the Bankruptcy Code. The case arises from a consolidated bankruptcy proceeding involving thirteen related debtors, among which Ellingsen MacLean Oil Company is the largest. The debtors are oil companies who provide, among other things, home heating oil to homes in the Marquette, Michigan area. These debtors were all operating under a Chapter 11 bankruptcy reorganization at the time the order at issue was entered.

On March 31, 1984, the bankruptcy court entered an Agreed Order authorizing the various debtors to use their assets, including cash collateral, which were subject to prepetition security interests held by appellees First National Bank and Trust Company of Escanaba and the Northern Trust Company (the Banks), the debtors' principal secured creditors. The Order also allowed the debtors to borrow an additional $500,000 from the Banks. As an incentive to the Banks to extend added credit, the debtors granted the Banks first and senior replacement liens on all of the debtors' assets pursuant to Bankruptcy Code section 364,[1] and the debtors agreed to make periodic payments to the Banks as permitted under other sections of the Code.

The debtors failed to make the agreed periodic payments, and the Banks filed a motion for relief from the automatic bankruptcy stay then in effect. In response, the debtors filed a petition for authority to settle the stay litigation, to amend the Agreed Order of March 31, 1984, and to obtain new cedit. The immediate need for new credit was to purchase needed home heating oil for delivery to approximately 1200 to 1500 customers during Christmas week.

The bankruptcy court held an emergency telephonic hearing. The debtors, the Banks, and the appellants, the Unsecured Creditors Committee and Mobil Oil Corporation, a major unsecured creditor, were all represented. After the hearing the bankruptcy court entered an order (the amended order), which

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[1] Section 364 of the Code authorizes the trustee to operate the debtor's business and obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) as an administrative expense. 11 U.S.C. §364(a). If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) as an administrative expense, the court may authorize the obtaining of credit or incurring of debt —

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.

11 U.S.C. §364(c).

is the source of dispute on this appeal. The amended order authorized the extension of new credit, including an immediate advance of $60,000 in cash and $175,000 made available in the form of letters of credit, with authority for the debtors to use the cash collateral pursuant to section 363. [2]As an incentive for the Banks to extend this further credit, they were granted first and senior replacement liens in all of the debtors' assets pursuant to section 364. The debtors also agreed to "settle all controversies regarding the validity of the Banks' security interests . . . by waiving any objections they may have with respect thereto . . . ."[3] The order further specifically stated that the validity of the liens granted "shall not be affected on appeal by reversal or modification of the authorization contained herein unless this Order is stayed pending appeal."

Appellants immediately appealed the bankruptcy court amended order to the district court. Appellants did not, however, obtain a stay of the order pending this appeal. Because no stay was in effect, the Banks filed a motion for dismissal pursuant to Bankruptcy Code section 364(e). The district court granted the Banks' motion and ordered dismissal. 65 BR. 358. Appellants now appeal for relief to this court.

Section 364(e) provides:

> The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

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[2] Section 363 allows the trustee to use, sell, or lease cash collateral, subject to prescribed conditions. *See* 11 U.S.C. §363.

[3] The unsecured creditors committee had alleged that the security interests for the loans had been arranged in a manner that constituted a fraudulent conveyance.

Appellants argue that dismissal pursuant to section 364(e) was in error because that section does not apply to the amended order. They argue further that even if section 364(e) does apply, the Banks did not extend money in good faith and thereby lost section 364(e)'s protection.

I. Does section 364(e) apply?

The contention that section 364(e) should not apply stems from the phrase "under this section", which limits the protection under subsection (e) to authorizations made under section 364(c). The amended order was purportedly made pursuant to section 364(c), but appellants argue that it exceeded the bounds allowed by section 364(c) and therefore is not entitled to 364(e) protection.

11 U.S.C. §364(c) provides:

> If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt —
>
> (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
>
> (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
>
> (3) secured by a junior lien on property of the estate that is subject to a lien.

11 U.S.C. §364(c).

The express language of this subsection suggests that the priority or lien granted thereunder is limited to securing the newly incurred debt authorized by that provision. Appellant urges this interpretation and finds support in two bankruptcy cases. *See In re FCX, Inc.*, 54 B.R. 833, 841 (Bankr.E.D.N.C.1985) (Section 364(c)(1) authorizes super priority for postpetition loans not prepetition loans); *In re Monarch Circuit Industries*, 41 B.R. 859, 862 (Bankr.E.D.Pa.1984) ("the terms of §364(c)

appear to limit the extent of the priority or lien to the amount of the credit obtained or debt incurred *after* court approval") (emphasis in original).

We read the amended order at issue as expressly granting section 364(c) priority only to postpetition debt. The bankruptcy court stated that "(a)ll Liabilities *other than Pre-petition Liabilities,* shall, to the extent not paid from collateral granted herein, be accorded priority pursuant to Section 364(c)(1) . . ." It also asserted that "the interest granted herein to the Banks in such Free Asset (previously unencumbered assets) shall be limited to security for only those Liabilities which are not Pre-petition Liabilities; . . ." This portion of the order, therefore, complied with appellants' interpretation of section 364(c).

The more troublesome aspect of the amended order is the portion in which the debtors agreed to "settle all controversies regarding the validity of the Banks' security interests . . ." Appellants contend that this aspect of the order, in essence, gave the Banks valid, perfected security interests securing *prepetition* loans. This, according to appellants, is beyond the scope of section 364(c) and therefore not protected by section 364(e).

This aspect of the order does not fit neatly into any of the aforesaid categories of section 364(c). It did not precisely create a new lien or priority; instead, it prohibited any challenges to the validity of already existing liens. This aspect of the order, however, was part of the whole "package" authorized under section 364(c). The question is whether section 364(c) allows such a transaction. *In re FCX* and *In re Monarch* both hold that section 364(c) authorizes priority or liens only for postpetition debt, not *prepetition* debt. This order in controversy bolstered liens securing prepetition debt, and thus may exceed the scope of section 364(c).

Even if the order were interpreted to exceed the scope of section 364(c), however, we are aware of no case authority holding that section 364(e) protection is unavailable to orders purportedly granted under section 364(c) but determined to have exceeded section 364(c)'s scope. *In re Monach* expressly declined to address this section 364(e) question. *See*

41 B.R. at 862. *In re FCX* never mentioned section 364(e) after ruling that section 364(c) does not authorize "super priority" for prepetition loans. *See* 54 B.R. at 841. If an order exceeded the scope of section 364(c), is it not entitled to section 364(e) protection, if purportedly granted under section 364(c) and relied on by the debtor and lending party concerned in good faith?

Appellants assert several policy reasons for their position that section 364(e) does not protect this amended order. First, appellants assert that "cross-collateralization" is generally disfavored as a financing mechanism. *See, e.g., In re FCX, Inc.*, 54 B.R. at 840; *In re Roblin Industries*, 52 B.R. 241, 244 (Bankr.W.D. N.Y.1985); *In re Antico Mfg. Co.*, 31 B.R. 103, 105 (Bankr.E.D.N.Y.1983); *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr.E.D.N.Y.1983). *In re Vanguard* set out a four part test to determine whether to allow cross-collateralization, which other courts have followed. *See In re Roblin*, 52 B.R. at 244; *In re Antico*, 31 B.R. at 105. Appellant argues that approving the cross-collateralization order and thus protecting it from review by applying the section 364(e) language, "unless . . . stayed pending appeal," thwarts the policy disfavoring cross-collateralization.

Cross-collateralization, however, although controversial, is often used, and even the courts that discourage it have approved its use. *See, e.g., In re Beker Industries*, 58 B.R. 725, 742-43 (Bankr.S.D.N.Y.1986); *In re B & W Tractor Co.*, 38 B.R. 613, 617-18 and 617 n. 12 (Bankr.E.D.N.C.1984); *In re Antico*, 31 B.R. at 105-06; *In re Vanguard*, 31 B.R. at 367. Because cross-collateralization seems to be used and approved, and appears to be a valuable financing tool in arranging postpetition credit to keep debtors in reorganization going, Congress would not have intended to exclude all cross-collateralization orders categorically from section 364(e)'s protection.

Appellants argue further that using section 364(e)'s language to shield the order in controversy from scrutiny, prohibiting any challenge to the Banks' security interests, is unfair to unsecured creditors and allows secured creditors to abuse the system. They point out that the Banks would receive protection from

any challenge to their security interests totalling some $4,000,000 value in exchange for an advance of only $60,000 in cash and making $175,000 available through letters of credit. If the Banks' security interest can be so fortified, the unsecured creditors, including plaintiffs, lose the chance to pursue the debtors' assets until the Bank's liens securing $4 million worth of debt are satisfied. Appellants point out that this could set a precedent for any secured creditor whose interest may be subject to challenge to take advantage of an "emergency" situation, and arrange a transaction similar to the one in controversy by advancing a relatively small amount of new credit.

There are countervailing strong policy reasons to encourage creditors to extend additional postpetition credit to debtors. Chapter 11 envisions the continued operation of a debtor's business, but the need for fresh capital and difficulties in obtaining the capital and wherewithal to run a business are obvious. Lenders and suppliers are understandably reluctant to do business with a debtor who is in bankruptcy and who may have few, if any, unencumbered assets to offer as collateral. Section 364 is designed to encourage postpetition financing by authorizing security in the debtor's assets and giving the lender priority over administration costs. It provides for approving such loans on an expedited basis after notice and a hearing. Subsection (e), in turn, protects the authorization for priority on a [illegible] from reversal or modification on appeal, as long as the order has not been stayed pending appeal and the creditor extended credit in good faith. This good faith requirement allays creditors' concerns about abuse of the process.

The *In re FCX* court discussed the competing concerns involved in postpetition financing:

> A lender makes advances in reliance upon such orders authorized by §364 and "(t)he chapter 11 process would be undermined if this Court were to, in effect, undo those orders . . . ." . . . Nevertheless, there is a difference between approval of a priority and a lien, which are specifically authorized under §364, and other terms which are not. Furthermore, the court should not ignore the basic injus-

> tice of an agreement in which the debtor, acting out of desperation, has compromised the rights of unsecured creditors.

54 B.R. at 838 (citations omitted).

Whether section 364 authorizes prohibiting a challenge to prepetition security interests was of concern to appellants, and they challenged this aspect of the amended order before the approval was given by the bankruptcy court. The unsecured creditors' interests are a concern in arranging postpetition financing, and several of the courts allowing cross-collateralization have noted that the unsecured creditors did not object. *See, e.g., In re Beker,* 58 B.R. at 742; *In re Vanguard,* 31 B.R. at 367. In this case, the appellants objected because they viewed their claims as compromised by the prohibition against challenging security interests which, if defeated, could make assets available for distribution to the unsecured creditors. The unsecured creditors were, however, allowed to express their concerns and objections at the hearing, which was held after adequate notice, and as long as the order was authorized under section 364, the order should be protected by section 364(e).

We note that in this case the Banks did not receive complete cross-collateralization. The order in several contexts seems to limit section 364(c) priority and security interest to *post* petition debt. The order thus did not unequivocally prefer the Banks over unsecured creditors by giving them security interests in previously unencumbered assets to secure prepetition debt, known as "forward cross-collateralization." *See In re Beker,* 58 B.. at 742 n.5; *In re Antico,* 31 B.R. at 105. We also hold that the mere allowance of cross-collateralization in some degree as a financing tool should not categorically deprive an order of section 364(e) protection. More important than the nature of the advantage given the Banks for extending further credit is the fact that unsecured creditors failed to obtain a stay.

Appellees argue that limiting section 364(e) protection to new advances only undercuts the goal of providing incentives to the creditor to extend postpetition credit. As this case illustrates, a more traditional section 364(c) arrangement, such as

the one entered on March 31, 1984 between these parties, may not suffice. The debtors were not making payments and needed new capital, but the Banks were not willing to cooperate on the same terms and conditions which had not been fulfilled. The Banks were seeking relief from the automatic stay by reason of default. The term in the amended order protecting the Banks from challenge to their security interests was necessary to induce the Banks to extend more credit in a risky situation. Since the debtor was experiencing continuing losses, more was at risk. The collateral base of the Banks was being depleted. Thus, if section 364(e) protection were limited in all cases to new advances, creditors might not be willing to extend more credit, and debtors would fail, probably after depletion of assets and collateral; all creditors would be losers in that situation.

The amended order in question used the word "settle" in referring to the agreement not to challenge the security interests, but the district court correctly found that the order was not so much a "settlement" as a term or condition of the bargain made between the debtor and creditor to encourage the creditor to extend further postpetition credit. In this situation the bankruptcy court should not be required to scrutinize carefully the legal arguments made and the position of the parties with respect to a new and amended loan agreement. The bankruptcy court thus did not violate the Supreme Court's mandate requiring strict scrutiny of settlements in bankruptcy. *See Protective Comm. for Indep. Stockholders v. Anderson*, 390 U.S. 414, 88 S.Ct. 1157, 20 L.Ed.2d 1 (1968).

Appellants finally argue that applying section 364(e) to protect the terms of the amended order results in a denial of due process. This argument is without merit. The order was not entered until after adequate notice and a hearing, in which appellants fully participated. Furthermore, and even more important, appellants could have avoided the application of section 364(e) by seeking a stay of the order pending appeal. Appellants might also have filed a motion for relief from the order pursuant to Bankruptcy Rule 9024 and Federal Rule of Civil Procedure 60, or a motion for a new trial under Bankruptcy Rule 9023 and Federal Rule of Civil Procedure 59. The unsecured creditors, despite the language of the amended order, do

not suggest that they ever sought a stay. Appellants took advantage of none of these available procedures, and therefore cannot now claim a denial of due process. The mere allowance of cross-collateralization to some degree as a financing tool should not categorically deprive an order of section 364(c) protection.

After consideration of the arguments and policy questions involved, we conclude that the amended order should also be deemed to be protected by the provisions of section 364(e). This amended order seems to some degree at least to have limited the newly created priority and security interest to postpetition debt, and to that extent would fall within the purview of section 364(c). It did not, in our view, exceed the intended scope of section 364. It did not create any new lien as such securing prepetition debt; rather, at most, it further secures prepetition debt by prohibiting any challenge to the prepetition security interests. Under the circumstances of this case, this condition seems to have been necessary to induce the Banks to extend more credit, which is the underlying purpose of section 364.

> These provisions seek to overcome people's natural reluctance to deal with a bankrupt firm whether as purchaser or lender by assuring them that so long as they are relying in good faith on a bankruptcy judge's approval of the transaction they need not worry about their priority merely because some creditor is objecting to the transaction and is trying to get the district court or the court of appeals to reverse the bankruptcy judge. The proper recourse for the objecting creditor is to get the transaction stayed pending appeal.

In re EDC Holding Co., 676 F.2d 945, 947 (7th Cir.1982). In the absence of any case law clearly indicating that section 364(e) cannot extend to the type of condition imposed in the bankruptcy court's order, we conclude that it does not exceed section 364(e)'s protection. This ruling does not ignore the unsecured creditors' interests. "The proper recourse for the objecting creditor is to get the transaction stayed pending appeal." *In re EDC Holding Co.* at 947.

II. Did the Banks act in bad faith?

Even if section 364(e) applies, as we have held, appellant contends that it does not protect the Banks in this case because they did not extend credit in good faith. The Bankruptcy Code does not attempt to define the term "good faith". The definition most often used is that of the Uniform Commercial Code at section 1-201(19): "Good faith means honesty in fact in the conduct or transaction concerned." A finding of good faith is a finding of fact, which is subject on review to the clearly erroneous standard. *See generally*, Fed.Rule Civ.P. 52; Bankruptcy Rule 7052. Both the bankruptcy court and district court found that the Banks had acted in good faith, limiting our review to the question whether these findings constituted clear error.

Appellants first argue that the Banks acted in bad faith by working closely with the debtors, not intending to lend any more money unless the debtors agreed not to challenge their security interests, and then waiting until an "emergency" existed to inform the court of their position. The district court found that this assertion basically charges the Banks with a conspiracy of sorts and assumes that the debtors and bankruptcy court were both duped into the agreement. The district court refused to find that the bankruptcy court had been duped by a conspiracy and concluded that the bankruptcy court justifiably found that a true emergency existed. The home heating oil situation is not disputed. At the time of the Amended Order, the debtors had only 120 gallons of oil available and already had orders for 11,000 gallons. The debtors' suppliers were reluctant to deliver more oil without certainty of payment, and the Banks were the only creditors willing to extend any more credit to the debtors, and only on the conditions heretofore discussed. Under these circumstances, and absent any evidence of a "conspiracy," the finding that the emergency was not contrived was not clear error.

Appellants' second argument is that the notice to the unsecured creditors was inadequate and the Banks acted in bad faith by proceeding on short notice. The Bankruptcy Code requires only "such notice as is appropriate in the particular circumstances. . . ." 11 U.S.C. §102(1)(A). The district court found that

the notice in this case was adequate under the circumstances. In emergency situations, as existed here, the notice requirements are necessarily more relaxed. The unsecured creditors received notice of the hearing, and they participated fully in the hearing. Appellants argue that the Banks and debtor had discussed an informal agreement earlier, and that they could have informed the other creditors earlier that the debtors would need relief from the court. This argument presumes that the Banks knew the debtor would seek an amended order from the court. The question is not what notice might have been given, but whether the notice actually given was adequate. In this case, we cannot find the district court to have been in error in deeming the notice to have been sufficient under the circumstances. The shortness of the time does not clearly indicate bad faith on the part of the Banks.

Finally, appellants argue that the Banks proceeded despite knowledge that the terms of the amended order would be challenged. This action allegedly constituted bad faith. The statute was intended to protect "the lender who believes his priority is valid but cannot be certain that it is, because of objections that might be upheld on appeal." *In re EDC Holding Co.*, 676 F.2d 945, 947 (7th Cir.1982). In this case, the Banks may have been uncertain about whether the terms of the order would be challenged or subject to reversal on appeal, but they cannot be deemed to have ***known*** that the conditions approved were improper. We find no clear error, therefore, in the determination that the Banks did not act in bad faith in this respect.

We accordingly AFFIRM the decision of the district court.

DAVID A. NELSON, Circuit Judge,
concurring.

I concur in the judgment of the court, but write separately to emphasize the limited precedential effect of our holding in this case and to explain why I read the bankruptcy court's amended

order as purporting, at least, expressly to grant §364(c) priority to pre-petition debt as well as to post-petition debt.

At the time of the filing of the debtors' voluntary petitions under Chapter 11 of the Bankruptcy Code, as the amended order recites, the debtors owed the Banks approximately $4.4 million. The Banks claim that this indebtedness was secured by valid liens on all of the debtors' assets. The unsecured creditors challenged the validity of the Banks' liens, but the bankruptcy court, which was familiar with at least some of the evidence bearing on that issue, found that there was "little likelihood" that the objections to the liens would be sustained. The bankruptcy court also found that the litigation expense to which the debtors' estates would be subjected if the objections to the Banks' liens were fully litigated would be at least $200,000. Under these circumstances, and in view of the unwillingness of the Banks to advance further credit or agree to the continued use of cash collateral unless the objections to the liens were waived, the court found that waiver of the objections to the liens would be in the best interests of the estates and their creditors.

It was against this background that the bankruptcy court authorized the obtaining of additional credit and granted "replacement liens" on all of the assets of the debtors. The amended order expressly stated that the replacement liens were granted as security for "all" liabilities of the debtors, including pre-petition liabilities, and at two separate places in the amended order it was expressly stated that the replacement liens were granted "pursuant to Section 364 of the Bankruptcy Code."

Pursuant to Section 364(c)(1) of the Bankruptcy Code the additional credit authorized by the amended order was given priority over all administrative expenses, and it is true that the pre-petition liabilities were not given priority over administra-

tive expenses. The replacement liens were clearly intended to give the Banks priority over unsecured creditors for the full amount of the pre-petition liability to the Banks, however, and I do not read the amended order's reference to Section 364(c)(1) as suggesting in any way that the bankruptcy court did not contemplate that the replacement liens, in their entirety, were granted "pursuant to Section 364 . . ." That understanding is confirmed by the penultimate paragraph of the amended order, which reads as follows:

> "This order is entered pursuant to Section 364 of the Bankruptcy Code. The validity of any credit extended by the Banks and any priority or lien granted pursuant to this Order shall not be affected on appeal by reversal or modification of the authorization contained herein unless this Order is stayed pending appeal."

I am uncertain whether Section 364 ought to be read as authorizing the bankruptcy court to grant liens securing pre-petition debt as well as the additional debt incurred on the strength of the amended order. Section 364(c)(2) does empower the bankruptcy court to authorize the incurring of additional debt "secured by a lien," however, and the statute does not expressly say that under no circumstances may such a lien secure pre-petition debt as well. In the case at bar everyone concerned was put on notice that the authorization to obtain credit and the grant of replacement liens securing all of the indebtedness to the Banks were made "under this section" (*i.e.* under Section 364) as far as the bankruptcy court was concerned, and given the particular circumstances of this case I cannot say that the bankruptcy court was completely unreasonable in construing the scope of its authority as broadly as it did. The unsecured creditors having been made aware of the bankruptcy court's position that under Section 364(e) the validity of the replacement liens would not be affected by reversal on appeal unless the amended order were stayed, it seems to me that the unsecured creditors acted at their peril in failing to obtain such a stay. I believe, therefore, that the district court acted correctly in dismissing the appeal whether or not

the granting of replacement liens securing both pre-petition and post-petition indebtedness was in fact authorized by Section 364.

MERRITT, Circuit Judge,
dissenting.

This case presents a rather simple issue: What is the scope and purpose of section 364(e) of the Bankruptcy Code? This section requires the issuance of a stay pending appeal before there can be a "reversal or modification on appeal" of a bankruptcy order granting a creditor "superpriority" in exchange for making an emergency extension of credit to a chapter 11 creditor. The purpose of the subsection is to deny unsecured creditors the right of appeal and thereby deny their right to upset a lien given superpriority unless the closing and completion of the credit transaction has been delayed by a stay granted by the Bankruptcy Court. This speeds the extension of emergency credit because lenders are assured that their security for the loan — the superpriority — will not be taken away after the funds have been advanced. If the security for such loans could be upset on appeal after the debtor has received the loan proceeds, there would be little incentive for a lender to make loans that keep chapter 11 debtors afloat.

In the case at bar, the banks made a $60,000 superpriority loan supplemented with a $175,000 letter of credit in order to allow the debtors to supply their customers living in the upper peninsula in Michigan with heating oil in the dead of winter. Obviously the loan and letter of credit are covered by section 364(e) and may not be challenged by the unsecured creditors because no stay was entered.

The more difficult question is whether the bankruptcy court's action in making incontestable more than three million dollars in prepetition loans made by the banks is likewise within section 364(e), thereby denying the unsecured creditors a right to appeal the Bankruptcy Court's ruling in this respect. I would hold that the right to appeal this aspect of the ruling is not cut off by section 364(e). This section is not designed to cut off the right to appeal rulings on *prepetition* matters, such as fraudu-

lent conveyances and preferences, but only affects authorized postpetition loans and liens to secure such loans. Lenders should not be permitted to use their leverage in making emergency loans in order to insulate their prepetition claims from attack. The banks here should not be permitted to make several million dollars in prepetition loans secure and uncontestable at the expense of the other creditors by the simple expedient of making a section 364 postpetition loan. The statute does not contemplate denying the right of appeal in such situations, and there is no authority permitting such a constraint on judicial review. I would therefore reverse the District Court's ruling that the bank's prepetition security interests are not subject to review and I would permit the unsecured creditors to pursue the fraudulent conveyance claim.

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 86-1452

Nov. 30, 1987

IN RE:

ELLINGSEN MacLEAN OIL COMPANY, INC.,

Debtor.

UNSECURED CREDITORS' COMMITTEE;
MOBIL OIL CORPORATION,

Plaintiffs-Appellants,

v.

FIRST NATIONAL BANK & TRUST COMPANY OF ESCANABA;
THE NORTHERN TRUST COMPANY,

Defendants-Appellees.

Before: MERRITT, WELLFORD and NELSON, Circuit Judges.

JUDGMENT

ON APEAL from the United States District Court for the Western District of Michigan.

THIS CAUSE came on to be heard on the record from the said district court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the judgment of the said district court in this case be and the same is hereby affirmed.

ENTERED BY ORDER OF THE COURT

John P. Hehman, Clerk

/S/John P. Hehman
Clerk

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MICHIGAN

In the Matter of:

ELLINGSEN MacLEAN OIL COMPANY,
et al., File No. M85-332 CA2

Debtor. April 30, 1986.

OPINION

MILES, District Judge.

This appeal stems from a final order of the United States Bankruptcy Court for the Western District of Michigan, Northern Division. The umbrella bankruptcy proceeding from which this appeal comes involves thirteen debtors. These debtors are thirteen oil companies who provide, among other services and products, home heating oil to families in the Marquette, Michigan area. The debtors as "debtors in possession" were all operating under a Chaper 11 reorganization at the time the order at issue was entered.

On December 21, 1984, after an emergency telephonic hearing, the bankruptcy court entered an order (hereinafter, referred to as the Christmas order) authorizing the settlement of an alleged controversy regarding the validity of the secured position of the two largest secured creditors as consideration for those creditors' agreement to advance additional emergency credit for the benefit of the debtors. The advances were used by the debtors to purchase home heating oil for distribution to their customers in Marquette during Christmas week. The two creditors, the Northern Trust Company and the National Bank

and Trust of Escanaba (hereinafter refered to as the banks), immediately advanced the debtors $60,000.00 in credit, and $175,000.00 was made available to these same debtors in the form of letters of credit.

The alleged controversy which was settled as consideration for this new extension involved loans made prepetition to the debtors and secured with collateral held by the debtors. The largest of these debtors is the Ellingsen MacLean Oil Company. Apparently, the debtors operated substantially as one unit. The loan monies were placed in a single account, which was drawn on by all the debtors. As security for this mutual loan the debtors gave as security collateral possessed by each individual debtor. The unsecured creditors committee challenged the propriety of the securing of these loans by collateral of all the debtors. It was alleged that by securing the loans in that manner the banks had shaped a fraudulent conveyance of certain properties of some of the debtors.

The Christmas order was appealed to the United States District Court by the unsecured creditors committee and Mobil Oil Corporation (hereinafter the committee and Mobil). Mobil was the largest unsecured creditor. Neither the committee nor Mobil obtained a stay of the Christmas order pending appeal. That omission provides the basis for the present motion to dismiss by the banks. The motion to dismiss is based on 11 U.S.C. §364(e) of the Bankruptcy Code which provides:

> The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, *unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.*

(Emphasis supplied).

Appellants argue that their appeal should not be dismissed pursuant to this section because the credit was not extended in good faith, and thus contravenes section 364 and the transac-

tion is void. Appellants state that this bad faith was indicated by the fact that the loan itself was illegal on its face, as it allows for allegedly improper cross-collateralization of security. They also allege that the loan was authorized by the bankruptcy judge only after the banks tailored a false "emergency" and that there was insufficient notice of this emergency hearing.

The findings of fact made by the bankruptcy court are to be reviewed by this Court under the "clearly erroneous" standard of Fed.R.Civ.P. 52.[1] The facts of this case are not to be reviewed *de novo* by this Court. Such a *de novo* review of the facts could only be made in a reconsideration motions in front of the bankruptcy court pursuant to Fed.R.Civ.P. 60(b).[2]

Discussion

Appellees' argument is very straightforward. Essentially, they assert that their loan to the debtors is protected from attack upon appeal because of the stay provision in section 364 of the Bankruptcy Code. The stay provision was added to the Code to ensure certainty for persons extending credit to a bankrupt under court authorization. One court noted that it was added to the Code to:

> overcome people's natural reluctance to deal with a bankrupt firm whether as purchaser or lender by assuring them that long as they are relying in good faith on a bankruptcy court's approval of the transaction they need not worry about their priority merely because some creditor is objecting to the transaction and is trying to get the district court or the court of appeals to reverse the bankruptcy judge.

In the Matter of EDC Holding Company, et al., 676 F.2d 945, 947 (7th Cir.1982).

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[1] *See* Bankruptcy Rule 7052.

[2] *See* Bankruptcy Rule 9024. As the Court noted in *In Re Monach Circuit Industries, Inc.*, 41 B.R. 859, 862 (Bkrtcy.E.D.Pa.1984), upon reconsideration the party extending credit cannot rely upon the protection of section 364(e), as the court then reviewing the case is the original tribunal and not an appeals court.

The policy behind section 364(e) is not new to the Bankruptcy Code. For example, section 363 deals with appeals from orders of the bankruptcy court which authorize a trustee or a debtor to make a transaction in the ordinary course of business. Subsection (m) of that section provides in pertinent part that the reversal or modification on appeal of an authorization under section 363 of a sale or lease of property does:

> not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease *were stayed pending appeal.*

(11 U.S.C. §363(m), emphasis added). *See In re Vetter Corporation,* 724 F.2d 52 (7th Cir.1983); *also see Willemain v. Kivitz,* 764 F.2d 1019 (4th Cir.1985).

The Court observes that the legislative history of section 364(e) indicates that it is the analog to section 363(m). *See,* H.Rep. No. 595, 95th Cong., 1st Sess. 346-347; S.Rep. No. 989, 95th Cong., 2d Sess. 5758 (1978), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5843-5844, 63026303.[3] Moreover, both section 363(m) and 364(e) are similar to Rule 805 stated that a motion for a stay must ordinarily be made before one could appeal a bankruptcy order which issued a certificate of indebtedness or authorized a sale of property.

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[3] The portions of the House and Senate reports that deal with section 364(e) are virtually identical. Here is the excerpt from the Senate Report:

> Subsection (c) provides the same protection for credit extenders pending an appeal of an authorization to incur debt as is provided under section 363(1) for purchasers: the credit is not affected on appeal by reversal of the authorization unless the authorization and the incurring of the debt were stayed pending appeal. The protection runs to a good faith lender, whether or not he knew of the pendency of the appeal.

[S.Rep.No. 989, 95th Cong., 2d Sess. 57-58 (1978), U.S.Code Cong. & Admin.News 1978, pp. 5843-5844.] The Court notes the obvious mechanical error in the report. The report states that section 364(3) is simliar to section 363*(1)*, not (m). The House Report states the same. It must be a mistake; because section 363*(1)* is not at all similar to section 364(e).

The policies behind section 364(e) are well established and grounded in common sense. The procedural safeguard forcing the request for a stay pending appeal serves to protect the rights of the lenders who extend credit. The good faith provision in that same section acts to protect the debtor, other creditors and the integrity of the bankruptcy court. Additionally, these same parties receive protection from section 364(c) which requires that the bankruptcy court not issue an order pursuant to section 364 except *after notice and hearing*. *See also* 11 U.S.C. §102, and Bankruptcy Rule 2002. Finally, the creditors adversely affected by what they perceive as a mistaken order, or one entered after there had been circumstances amounting to a fraud upon the bankruptcy court, may move for reconsideration pursuant to Fed.R.Civ.P. 60(b).[4]

1. Notice & The "Tailored Emergency"

The Bankruptcy Code, section 364(c), provides that the trustee or debtor in possession may obtain credit or incur a debt only "after notice and a hearing". That phrase is defined by section 102 of the Code as meaning:

> such notice as is appropriate in the particular circumstances, and such opportunity for a hearing is appropriate in the particular circumstances; but
>
> (B) authorizes an act without an actual hearing if such notice is given properly and if —
>
> (i) such a hearing is not requested timely by a party in interest; or
>
> (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act.

Because the interests of other creditors may be prejudiced through the granting of a section 364(c) priority, due process requires that such creditors receive notice and a chance to object to the priority at a hearing before the bankruptcy court.

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[4] *See* Bankruptcy Rule 9024; *also see* footnote 2, *supra*.

See Mullane v. Central Hanover Bank and Trust Co., 339 U.S. 306, 70 S.Ct. 652, 94 L.Ed. 865 (1950); *In re Adamson Co., Inc.*, 29 B.R. 937 (Bkrtcy.E.D.Va.1983). Of course, in emergency situations the appropriate notice and hearing are not subject to the strict requirements of Bankruptcy Rule 1002. In the instant case, the record is clear that the notice provided was short. However, considering the circumstances, it cannot be said that adequate notice was not given to the parties. Nor can these same parties challenge the transaction on the grounds that they were not afforded a full and thorough hearing.

On Thursday, December 20, 1984, the debtors filed their "Petition for Authority to Settle Stay Litigation, To Amend Agreed Order, and To Obtain New Credit." The petition was filed with the ultimate goal of receiving new credit with which to purchase home heating oil the following Monday for delivery to approximately 1,200 - 1,500 customers during Christmas week. Accordingly, the petitioners requested an order finding that an emergency situation existed, thus authorizing a telephonic conference for the next day, Friday, December 21 at 3:00 P.M. The emergency finding was made by the bankruptcy court and the next day at the appointed time a telephonic hearing was convened. It is not exactly clear from the record exactly how all the parties were notified of the hearing; some received telex communications, some received letters, and others were notified over the telephone, while some people received word of the hearing through two or more of these mediums. Present at the hearing were counsel for First National Bank & Trust Company of Escanaba and counsel for the Northern Trust Company (the present appellees), counsel for Mobil and the unsecured creditors committee (the present appellants), counsel for the debtors, and counsel for the Lakeland Bank, one of the larger creditors.

This Court is satisfied that the bankruptcy court committed no error in holding the emergency hearing upon short notice. From the statements contained in the verified petition, and from his knowledge of the case gleaned from past proceedings between these very same parties, the bankruptcy judge could very safely operate under the assumption that an emergency situation was present. Moreover, through the convenient con-

vention of the telephonic hearing, the rights of the pertinent parties were preserved as they were afforded a full hearing before the bankruptcy court.

During the hearing, statements were heard from counsel and testimony elicited from two witnesses. The first was John Carey, the vice president and chief financial officer of Ellingsen MacLean Oil Company and signator of the verified petition. Testimony was also heard from J. C. Bullock of the J. C. Bullock Oil Company.

At the hearing Mr. Carey testified at great length concerning the assets of the debtors. The bankruptcy court was informed that the debtors had only 120 gallons of home heating oil available in the Marquette area and already had orders for approximately 11,000 gallons. (Transcript of emergency hearing at pp. 9, 13). Furthermore, in their bank accounts, the debtors had absolutely no ready cash with which to purchase fuel oil. (Tr. at p. 20). The debtors were unable to receive financing from any other source because of their poor financial position as a bankrupt. He further testified that the only sources willing to meet the debtors' needs were the two banks. However, the banks would only extend further credit upon the condition that the debtors were willing to settle the controversy regarding the fraudulent conveyance argument. (Tr. at pp. 12, 43-44). The testimony of both Mr. Carey and Mr. Bullock corroborate each other as to the fact that within approximately ten days time, the debtors could shift their home heating accounts to other suppliers who could serve those customers. (Tr. pp. 22-23, 55, 58). However, the debtors were loathe to take that step because it would mean the loss of a major asset, those very same accounts. That would greatly reduce the going concern value of the debtor companies.

After hearing examination and cross-examination of these witnesses, the bankruptcy judge issued his order based on the hearing and the verified petition. In his order he acknowledged that he was authorizing more than merely further financing pursuant to section 364, he would in effect be terminating any challenge towards the alleged fraudulent conveyance. (Tr. pp. 68, 69). In a previous hearing, the bankruptcy court had noted

that it was uncertain as to the status of the banks' security interest; although they appeared to be legitimate, it was possible to make a legal argument challenging their validity.[5] Nonetheless, in the Christmas Order, the bankruptcy court recognized the bargain presented by the banks as the only alternative to keep the debtors viable as a going concern. Accordingly, the order was signed by the bankruptcy judge on December 21, 1984.

Appellants have asserted arguments that the emergency was contrived by the banks; that the banks had backed down at the last minute from promises to keep funding the debtors, thus leaving the debtors sitting on a limb with no hope of receiving emergency funding from any other source during Christmas week. In essence, that argument necessitates a finding by this Court that not only where (sic) the debtors misled by the banks, but that the bankruptcy court was likewise conned into the plan. This the Court cannot do because there are no plain facts on the record which could support such a finding of a "bank conspiracy." As the Court has indicated earlier in this opinion, had the appellants truly believed that the appellees had "duped" the bankruptcy court into signing an improper order, the proper recourse would have been to make a motion for reconsideration pursuant to Fed.R.Civ.P. 60(b).

Rather than finding the existence of a "bank conspiracy" this Court is convinced that the bankruptcy court made a justifiable ruling that an emergency existed. There exists no clear error which would allow this Court to overturn the findings of the bankruptcy court.

2. Good Faith

The central attack by appellants' (sic) against the loan extended by the appellees is that the loan was not extended in good faith and as such is inherently violative of section 364.

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[5] *See* Opinion on Substantive Consolidation signed by Judge Heitman of the Bankruptcy Court on December 19, 1984.

Appellants point towards three factors to evidence this lack of good faith. The first two factors, insufficient notice and the "tailored emergency" were discussed in the previous portion of this opinion. The remaining argument focuses in on the form of the loan transaction. Appellants assert that the loan allows for illegal cross-collateralization. Furthermore, appellants assert that the appellees knew at the time the debtors sought authorization that the loan transaction called for such illegal cross-collateralization. Thus, that knowledge is indicative of bad faith.

The Bankruptcy Code does not supply a definition of good faith. The most used definition of the term is found in the Uniform Commercial Code at §1-201(19): "Good faith means honesty in fact in the conduct or transaction concerned." Regarding section 364(e) and the good faith provision, one court noted that section 364 was intended to:

> protect not the lender who seeks to take advantage of a lapse in oversight by the bankruptcy judge but the lender who believes his priority is valid but cannot be certain that it is, because of objections that might be upheld on appeal. If the lender *knows* his priority is invalid but proceeds anyway in the hope that a stay will not be sought or if sought will not be granted, we cannot see how he can be thought to be acting in good faith.

Matter of EDC Holding Co., 676 F.2d 945, 947 (7th Cir.1982). The Court further stated that:

> Where it is evident from the loan agreement itself that the transaction has an intended effect that is improper under the Bankruptcy Code, the lender is not in good faith, and it is irrelevant what the improper purpose is.

Id. at 948. In that case, the Seventh Circuit held that the lenders had not acted in good faith because the lenders knew that a portion of the funds extended to the debtor was for an obvious improper purpose: to pay attorneys fees to certain creditors, which fees are not allowed payment under any provision of the Code.

Contrasting the facts of the *EDC Holding* case with the instant case supports dismissal of this appeal. In the present

case, the funds were extended to the debtors for an undeniably proper purpose under the Code: to keep the debtors operating as a going concern by affording them an opportunity to service their customers.

Appellants argue that the improper purpose served by the agreement is that it grants the banks cross-collateralization of their security by allowing both prepetition and postpetition debts of the debtor to be secured by collateral acquired both prepetition and postpetition. In support, appellants cite to *In re Monach Circuit Industries, Inc.*, 41 B.R. 859 (Bkrtcy. E.D. Pa.1984).[6] This Court observes that while *Monach* may stand for the proposition that cross-collateralization places unsecured creditors in an unreasonable position, there are still numerous courts that have held cross-collateralization permissible in some circumstances. *See, In Re FCX, Inc.*, 54 B.R. 833, 840 (Bkrtcy. S.D.N.Y.1985); *In Re B & W Tractor Company, Inc.*, 38 B.R. 613 (Bkrtcy. E.D.N.C.1984); *In Re Antico Manufacturing Company, Inc.*, 31 B.R. 103 (Bkrtcy.E.D.N.Y.1983); *In Re Vanguard Diversified Inc.*, 31 B.R. 364 (Bkrtcy.E.D.N.Y.1983); *In Re Borne Chemical Company, Inc.*, 9 B.R. 263 (Bkrtcy.D.N.J.1981). Accordingly, this Court rules that unlike the lender in *EDC Holding*, the banks in the present case did not, nor could not, have a sound basis for "knowing" that their loans were illegal. All that could be said for that proposition is that at the time the petition was before the bankruptcy court, it was possible that the debtors and the banks were aware that certain legal arguments existed which opposed such a loan formulation. However, that is a far cry from having knowledge and certainty that a particular transaction is illegal or improper. Based on the

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[6] The Court in *In Re Monach*, 41 B.R. at 861-862 observed that cross-collateralization provisions should never be approved *ex parte*, but only after notice and a hearing. It also noted that in certain instances such a provision if properly authorized could constitute an unlawful preference in violation of 11 U.S.C. §547(b). However, that court never approached the crucial issue regarding the impact of section 364(e) on attacks upon loans containing such provisions. The *Monach* court was making its review upon a motion for reconsideration and not upon appeal, thus the stay provisions of section 364(e) had no application.

relevant case law and the facts in the record, this Court must find that the banks and the debtors acted in good faith in promulgating the loan transaction. Thus, appellees will be afforded the full protection of section 364(e).

Finally, appellants raise the argument that regardless of the protection offered by section 364(e), the agreement must be voided by this Court because it is in reality a settlement of potential litigation and not just a financing agreement pursuant to section 364 of the Code. The Court acknowledges that the terms of the Christmas Order entail more than a simple extension of credit, however the Court refuses to characterize the order as purely a settlement of a controversy.[7] Accordingly, the guidelines set forth by the supreme Court in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424, 88 S.Ct. 1157, 1163, 20 L.Ed.2d 1 (1968) do not have as direct application in this case as do the strictures of section 364 of the Code.

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[7] It was noted in *In re FCX, Inc.*, 54 B.R. 833 (Bkrtcy.S.D.N.Y.1985), that postpetition financing in a chapter 11 case is fraught with dangers for creditors. Accordingly, the frequent result "is a postpetition financing agreement calling for substantial concessions from the debtor, often at the expense of the rights of unsecured creditors." *Id.* at 838. It was that court's observation that without such financing a debtor's business may close and the going concern value of creditors' collateral be irretrievably lost, thus increasing loss to *all* creditors. This court agrees that in appropriate situations, it would be necessary, and indeed prudent, for a postpetition debtor to enter into a "hard" bargain with a creditor in order to acquire needed funds to complete a reorganization.

Some of the terms of the bargain reached between debtor and creditor may reach beyond the usual terms of a loan agreement. However, such terms are perfectly normal considering the "unusual" situation of a bankrupt firm. In such situations the bankruptcy court would rightfully be more interested by the requirements and provisions of section 364 of the Code, than it would be by a picayune examination of every legal argument that could be brought against separate provisions of the proposed agreement. Especially since after authorization by the bankruptcy court, such arguments are not considered foreclosed unless the concerned parties do not obtain a stay of the order. Thus, if such an omission occurs, than [sic] a situation arises against which seciton 364(e) was particularly drafted to protect.

Conclusion

Appellees motion to dismiss the appeal is GRANTED. The appeal is dismissed with prejudice.

IT IS SO ORDERED.

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF MICHIGAN
NORTHERN DIVISION

In the Matter of:

ELLINGSEN MACLEAN OIL COMPANY, *et al*

JUDGMENT IN A CIVIL CASE

Case No.: M85-332 CA

Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that the appellees motion to dismiss the appeal is granted. The appeal is dismissed with prejudice.

April 30, 1986

Gerald H. Liefer
Clerk

/S/Arthur C. Langeveld
(By) Deputy Clerk

IN THE UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF MICHIGAN NORTHERN DIVISION

IN RE:	Chapter 11
ELLINGSEN MacLEAN OIL CO., INC., And Related Cases, Federal Tax Identification No.: 38-1485138,	Bankruptcy Case No. 84-00033

Debtors.

AMENDED ORDER AUTHORIZING THE DEBTORS TO OBTAIN CREDIT

At Marquette, Michigan,
In Said District and Division
This 21st day of December, 1984.

This cause coming to be heard upon the Application of the Debtors ELLINGSEN MacLEAN OIL CO., INC., BAY DE NOC OIL CO., INC. BERRY OIL CO., CONTRACT OIL CO., INC., DAHLKE OIL CO., ESCANABA OIL CO., INC., GLADSTONE OIL CO., INC., HEBERT OIL CO., INC., NORTH WISCONSIN OIL CO., INC. RAISH DISTRIBUTORS, INC., RITCHIE OIL CO., INC., TERNUS OIL CO., INC. and WALCO OIL CO., INC. ("Debtors in Possession") for entry of an Order (a) authorizing the Debtors in Possession to settle a controversy, (b) granting the First National Bank & Trust Company of Escanaba and the Northern Trust Company (collectively, the "Banks") adequate protection and security for additional post-petition advances to the Debtors in Possession by means of a first and senior lien and security interest in after-acquired property cross-collateralized with prepetition debt to the Banks and the making of certain payments by the Debtors in Possession to the Banks, and (c) amending the Agreed Order previously entered by this Court on

March 31, 1984 (the "Agreed Order"); upon the agreement of the Banks, the Debtors and the Debtors in Possession; the Court being fully advised in the premises; upon notice to all counsel of record; upon a finding that a emergency exists as more fully described below; and upon the completion of hearings as provided under Section 363 and 364 of Title 11, United States Code, Section 101 et seq. (the "Bankruptcy Code");

THIS COURT FINDS:

1. The Debtors in Possession filed their voluntary petitions under Chapter 11 of the Bankruptcy Code on February 6, 1984.

2. Prior to the initiation of these proceedings, certain of the Debtors borrowed money from the Banks in accordance with certain loan and security documents, financing statements and amendments thereto, all of which are attached hereto as Group Exhibit A ("Loan Agreements").

3. Pursuant to the Loan Agreements, the Banks have asserted valid, perfected, first security interests, liens and encumbrances in all of the Debtors' assets, including the Debtors' accounts receivable (the "Cash Collateral"), inventory, equipment, machinery, general intangibles, and certain real estate and fixtures. The Debtors received a reasonably equivalent value in exchange for the grant of the security interests, liens and encumbrances. As of February 6, 1984, the Debtors were indebted to the Banks in the approximate aggregate sum of at least $4,400,000, subject to verification and accounting.

4. On or about March 31, 1984, this Court entered an Agreed Order (1) authorizing the Debtors in Possession to use their assets, including Cash Collateral, which are subject to the Banks' security interest; (2) allowing the Debtor to borrow an additional $500,000 from the Banks. In order to induce the Banks to allow the use of the Cash Collateral and to advance new credit, the Debtors agreed to grant the Banks first and senior replacement liens upon all of the Debtors' assets pursuant to Section 364 of the Bankruptcy Code, and to provide

adequate protection of the interests of the Banks in the form of certain periodic payments pursuant to Sections 361 and 363 of the Bankruptcy Code.

5. The Debtors have failed to make the periodic payments required under the terms of the Agreed Order.

6. On or about December 21, 1984, the Banks filed a motion for relief from the automatic stay, alleging that the Banks' interests were not adequately protected.

7. An immediate need exists for the Debtors to borrow additional money from the Banks in order to maintain operations as a going concern.

8. An emergency exists justifying the waiver of the 20-day notice required under Bankruptcy Rule 2002.

9. The Debtors in Possession are unable, pursuant to Section 364(a) or (b) of the Bankruptcy Code, to obtain unsecured credit allowable under Section 503(b)(1) of the Bankruptcy Code as an administrative expense, or, pursuant to Section 364(c) or (d) of the Bankruptcy Code, priority or secured credit from sources other than the Banks.

10. Without the proposed borrowings from the Banks the operations of the debtors cannot be maintained as profitable going concerns, and the debtors would in all likelihood cease operating on December 21, 1984 and be forced to liquidate.

11. In the event of liquidation it is doubtful whether unsecured creditors would receive any distributions from these estates after the payment of secured obligations to the Banks and priority tax obligations estimated to be at least $3,300.000.

12. The Banks have agreed (1) to allow the Debtors in Possession to continue to use the Cash Collateral; and (2) to advance up to $60,000 in additional credit to the Debtors in Possession, all in accordance with the terms and conditions of this Order.

13. The Banks will not advance additional funds as long as there is any controversy pending regarding the validity of the Banks' security interests.

14. In order to induce the Banks to agree to the entry of this Order allowing the Debtors in Possession to continue to use the Cash Collateral, to advance new credit to the Debtors in Possession, the Debtors and Debtors in Possession have agreed and hereby agree to grant the Banks first and senior replacement security interests, liens and encumbrances in all of the Debtors in Possession's assets, including accounts receivable, inventory, machinery, equipment, general intangibles and certain real estate and fixtures pursuant to Section 364 of the Bankruptcy Code and to make certain payments as hereinafter specified, as security for all Debtors in Possession's Liabilities as defined below and on the terms more fully set forth herein. The Debtors in Possession have also agreed to settle all controversies regarding the validity of the Banks' security interests, liens and encumbrances by waiving any objections they may have with respect thereto, including without limitation that guarantees of one Debtor's Liabilities by another Debtor were not given in exchange for reasonably equivalent value, except as set forth below.

15. It is in the best interests of these estates and their creditors for all objections to the Bank's security interests, liens and encumbrances to be waived as set forth below for the reasons that: (a) there is little likelihood, considering the evidence admitted at the hearings held by this Court with respect to the Debtors' Motion for Substantive Consolidation, that such objections will be sustained; (b) the expense to these estates of litigating such objections is estimated to be at least $200,000; and (c) the Banks will not agree to lend additional funds to the Debtors or agree to the continued use of Cash Collateral on terms other than those set forth herein, including without limitation a waiver of such objections. 16. The entry of this Order will minimize disruption of the Debtors in Possession as going concerns, will increase the possibilities for their successful reorganization and is in the best interest of these estates and their creditors.

The Court having read and considered said application, having received evidence and hearing argument of counsel with

respect to said application and with respect to the immediate financial need and continuation of the businesses of the Debtors in Possession;

NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED and DECREED as follows:

(a) The paragraphs contained in the preamble to this Order are incorporated herein by reference, and the Debtors, Debtors in Possession and the Banks consent and stipulate to the entry of this Order.

(b) This Order is an amendment to the Agreed Order, the terms of which shall continue to be in full force and effect except as expressly amended or inconsistent with the terms and conditions hereof.

(c) Twenty-day notice required under Bankruptcy Rule 2002 is hereby waived for good cause shown.

(d) The Debtors be and hereby are authorized as Debtors in Possession to use the Cash Collateral as provided in Section 363 of the Bankruptcy Code.

(e) "Liabilities" shall mean all liabilities, obligations and indebtedness heretofore, now or hereafter owing, arising, due or payable from Debtors and Debtors in Possession to Banks, howsoever evidenced, created, incurred, acquired or owing, whether primary, secondary, direct, contingent, fixed or otherwise, including, without limitation, Debtors' liabilities assumed by Debtors in Possession pursuant to paragraph (g) hereof and advances of new credit by the Banks to the Debtors in Possession. "Pre-petition Liabilities" shall mean that portion of Liabilities due and owing from all of the Debtors to the Banks upon the filing of the petitions commencing these cases.

(f) To secure the Liabilities, the Debtors in Possession are authorized, ordered and directed to grant and hereby grant to the Banks a first and senior replacement lien upon all of the property of these estates and all proceeds thereof pursuant to Section 364 of the Bankruptcy Code, subject only to other prior valid and perfected liens and security interests existing on the date of the initiation of these proceedings, including all present

and future accounts, contract rights, purchase orders, documents (including all warehouse receipts issued at any time by any public or private warehouse company representing inventory deposited in any such warehouse and all bills of lading), chattel paper, instruments, insurance policies, general intangibles (including but not limited to all causes of action and claims to tax refunds which this estate may assert), materials, supplies, inventory, work in process, finished goods, machinery, equipment, appliances, tools, machine tools, accessories, parts, materials, furniture, real estate, fixtures, goods and chattels of every kind and wherever located, all substitutions, renewals, improvements, replacements of, any additions to any and all of the foregoing and all proceeds and products thereof. All Liabilities other than Pre-petition Liabilities shall, to the extent not paid from collateral granted herein, be accorded priority pursuant to Section 364(c)(1) of the Bankruptcy Code.

(g) Debtors in Possession hereby agree to pay and to assume all of the respective Debtors' Pre-petition Liabilities and Liabilities to the Banks. Further, Debtors in Possession hereby agree to reimburse and assume all obligations to the Banks for all filing and recording fees and the reasonable attorneys' fees, costs and expenses incurred by Banks in connection with the negotiating, closing, and documenting the transactions between Banks and Debtors in Possession contemplated by this Order subject to court approval with respect to attorneys' fees. If at any time or times hereafter the Banks employ counsel for advice or other representation: (i) with respect to any of the Debtors' collateral, Debtors in Possession's collateral, Loan Agreements, or this order and/or any agreements related hereto; (ii) to protect, collect, lease, sell, take possession of, liquidate or otherwise dispose of any of Debtors' collateral, or Debtors in Possession's collateral; (iii) to attempt to enforce any security interest or lien of Banks in Debtors' collateral or Debtors in Possession's collateral; or (iv) to enforce any rights of the Banks against Debtors or Debtors in Possession or against any other person which may be obligated to the Banks by virtue of this Order and/or any agreements related hereto, including Debtors or Debtors in Possession's account debtors; then upon each such occurrence all of the reasonable attorneys' fees arising

from such services and all expenses, costs and charges in any way or respect arising in connection therewith or relating thereto shall constitute a part of Debtors in Possession's Liabilities subject to the provisions of the Bankruptcy Code and court approval with respect to such fees.

(h) This Order shall be deemed to be a security agreement. The security interests, liens and encumbrances herein granted are and shall be in addition to all security interests, liens or encumbrances existing in favor of the Banks on the date of the commencement of these cases. Said first and senior replacement security interests, liens and encumbrances shall be valid, perfected, enforceable and effective as of the date of the commencement of this case without any further action by the Debtors in Possession and without the execution, filing or recordation of any financing statements, security agreements or other documents. If the Banks hereafter requst the Debtors in Possession to execute or deliver to the Banks financing statements, security agreements or other instruments or documents considered by the Banks to be necessary or desirable to perfect the security interests and liens granted to it herein, the Debtors and Debtors in Possession are authorized to execute such documents, and the Banks are authorized to receive, file and record the same. Such agreements shall include, but are not limited to, a security agreement in the form attached hereto as Exhibit B. For such purposes the automatic stay in effect as against the Banks is hereby vacated.

(i) The Banks shall be deemed to have a good, valid and perfected security interest, lien and encumbrance in and to all assets of the Debtors in Possession including without limitation all accounts receivable, equipment, machinery, inventory, general intangibles and certain real estate and fixtures and all proceeds thereof of the Debtors upon the terms set forth herein. However, if either of the Banks was not, pursuant to the agreements set forth in Exhibit A hereto, expressly granted a security interest, lien or encumbrance in or did not perfect any such interest, lien or encumbrance under applicable Michigan law with respect to any asset of the Debtors (a "Free Asset"), the interest granted herein to the Banks in such Free Asset shall be limited to security for only those Liabilities which are not

Pre-petition Liabilities; provided, however, that (1) nothing else shall affect the validity of the Banks' security interest, lien or encumbrance granted pursuant to the terms of this Order; and (2) this Court expressly finds that any security interest, lien or encumbrance granted to and perfected by the Banks as set forth in Exhibit A hereto is valid, perfected and granted in consideration for reasonably equivalent value by each of the Debtors.

(j) If, in the course of the reorganization proceedings, liens are granted to others pursuant to Section 364(d) of the Bankruptcy Code, which liens are senior or equal to the liens of the Banks described above, then the proceeds of any such loans or extension of credit secured by such senior or equal liens shall be applied first to satisfy the Liabilities, or, in the case of Free Assets, Liabilities except for Pre-petition Liabilities.

(k) The Debtors in Possession shall make or cause others to make regular periodic payments to the Banks in the amounts specified on the schedule attached hereto as Exhibit B, unless otherwise agreed in writing by the Banks, subject only to accounting verification, as elements of the adequate protection of the interests of the Banks, which amounts shall be credited against the Liabilities, first to interest and expenses (subject to the provisions of the Bankruptcy Code and court approval with respect to attorneys' fees) and then to principal.

(l) The Debtor or Debtors in Possession may not (1) object to the lifting of the automatic stay with respect to the Banks upon any default under the terms of this Order or any Exhibit hereto and upon application of the Banks; (2) object to the conversion of any of these Chapter 11 proceedings to Chapter 7 proceedings pursuant to Section 1112 of the Bankruptcy Code upon application of the Banks made not less than 180 days after the entry of orders for relief in these cases; and (3) request pursuant to Section 1121 of the Bankruptcy Code extensions of the period during which only the Debtor in Possession may file plans of reorganization beyond 180 days after the entry of orders for relief in these cases; provided, however, that nothing herein shall affect the rights of any other parties in interest, including the Creditors Committee, with respect thereto.

(m) Notwithstanding any provisions of this Order, the Debtors in Possession shall deposit all cash proceeds received by them from any sources whatsoever with the Banks.

(n) The provisions of this Order shall be binding upon and inure to the benefit of the Banks, the Debtors, the Debtors in Possession and their respective successors and assigns including without limitation any trustee in bankruptcy hereinafter appointed for any of the Debtors in Possession's estates.

(o) This order is entered pursuant to Section 364 of the Bankruptcy Code. The validity of any credit extended by the Banks and any priority or lien granted pursuant to this Order shall not be affected on appeal by reversal or modification of the authorization contained herein unless this Order is stayed pending appeal.

(p) Nothing herein shall be deemed to constitute an assumption or rejection of any executory contracts of the Debtors in Possession, and all rights are hereby fully preserved with respect to the assumption or rejection of executory contracts.

DATED: December 22, 1984.

/s/ Marvin Heitman

MARVIN HEITMAN
United States Bankruptcy Judge

Prepared by Counsel for
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No. 86-1452

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

[Filed Jan 15 1988]

IN RE: ELLINGSEN MACLEAN OIL CO., INC. &

RELATED CASES,Debtor

UNSECURED CREDITORS' COMMITTEE; MOBIL OIL CORP., ORDER

Plaintiffs-Appellants

v.

FIRST NATIONAL BANK & TRUST CO. OF ESCANABA, THE NORTHERN TRUST COMPANY,

Defendants-Appellees

BEFORE: WELLFORD, MERRIT, and NELSON, Circuit Judges

The Court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this Court, and no judge of this Court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

(s) John P. Hehman

John P. Hehman, Clerk

UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF MICHIGAN

IN RE:

ELLINGSEN MacLEAN OIL CO., INC., a corporation, and related cases,	CASE NO. 8400033 Chapter 11
Debtors.	[December 19, 1984]

OPINION

Substantive Consolidation

APPEARANCES:

Donald Bays, Attorney for Debtors
Robert Sawdey, Attorney for Creditors' Committee
David Heroy, Attorney for Northern Trust Company
Thomas Butch, Attorney for First National Bank of Escanaba
Tim Curtin, Attorney for Mobil Oil Corporation
Peter Shumar, Attorney for Lakeland State Bank

This matter is before the Court upon the Motion of the Debtors-in possession for "substantive consolidation" of the above thirteen Chapter 11 Debtors. The Debtors-in-possession seek the merger of the assets and liabilities of all thirteen into a single bankruptcy proceeding. The Court had previously ordered that the cases be consolidated for purposes of administrative convenience.

Northern Trust Company and the First National Bank of Escanaba have joined in supporting the motion of the Debtors. The motion is opposed by the Creditors' Committee and creditors Mobil Oil and the Lakeland State Bank.

Bankruptcy Rule 1015 provides for consolidation or joint administration of cases pending in the same Court, but as the Advisory Committee Note indicates, does not deal with the

consolidation of cases involving two or more separate debtors. The Committee Note goes on to point out that:

> "Consolidation, as distinguished from joint administration, is weither authorized nor prohibited by this Rule since the propriety of consolidation depends upon substantive considerations and affects the substantive rights of the creditors of the different estates."

"Substantive consolidation is the consolidation of the assets and liabilities of different entities which are then dealt with as if the assets were held by and the liabilities were incurred by a single entity." *In Re Manzey Land & Cattle Company*, 17 BCR 332, 5 CBC 2d 1481, Collier on Bankruptcy, Page 1100-32, 15th Ed. 1980.

A further effect of substantive consolidation is to eliminate interentity claims. The power to substantively consolidate is contained in 11 U.S.C. Section 105(a), which vests the Bankruptcy Court with the power to issue:

> ". . . any order, process, or judgment that is necessary or appropriate to carry out the provisions of this Title."

A number of Courts have held that whether substantive consolidation is appropriate or not depends upon a number of factors: (1) whether the debtor has consolidated its business and financial records or has maintained separate records for each entity; (2) whether there is a unity of ownership amongst the debtors; (3) the existence of interentity transactions; (4) whether there has been a transfer of assets between entities without observance of corporate or other legal formality; (5) whether there has been a commingling of assets in business function; (6) the difficulty or ease of segregating and ascertaining separate assets and liabilities and the administrative benefits to be derived from consolidation. *In Re Richton International Corporation*, 12 BR 555, Bankruptcy So. Dist. of NY 1981; *In Re Vecco Construction Industries*, 4 BR 407, 2 CBC 2d 216, Bankruptcy E. Dist. of VA 1980; *In Re Llewellyn*, 26 BR 246, 7 CBC 2d 1060, Bankruptcy So. Dist. of IA 1982; *In Re Manzey Land & Cattle Company, supra; In Re Matter of Luth*, 28 BR 564, Bankruptcy 1983.

Generally, the evaluation of the factors or elements involved in substantive consolidation reduces itself to whether ordering consolidation will be equitable to the creditors of all of the entities without any undue prejudice to any particular group of or individual creditors.

The Debtors had consolidated their bank accounts a number of years past because of cash flow problems that the individual Debtors were having. Nonetheless, each check issued on the joint account was issued in the name of an individual entity. The main reason that the Debtors seek substantive consolidation is that their inter-entity accounts are hopelessly mixed up, primarily because of inventory transfers between companies, which the Debtors claim has resulted in an out-of-balance condition of approximately $5,000,000. Cost estimates for rectifying this situation range from $50,000-$100,000 by the examiner appointed by the Court to sums less than this claimed by the Creditors' Committee, if the work could be done by in-house personnel. In fact, no one knows what the cost might be to rectify inter-company accounts.

The Debtors further claim that no prejudice to creditors would result as a result of substantive consolidation because the secured creditors, Northern Trust Company and the First National Bank of Escanaba, are secured by all of the assets of all the companies, and that all of the companies have guaranteed the loans to those lending institutions. The Debtors further claim that were the companies liquidated, all assets would be needed to satisfy the secured creditors' claims, and none would be available for the unsecured creditors in any event. If true, this would largely disspell (sic) any concerns about fairness to creditors of the individual entities.

However, the Creditors' Committee argues that this may not be the case inasmuch as the secured creditors' security interest in the individual entities' assets may be voidable for want of consideration to the individual entities. If the latter case were true, then both objecting creditors, Mobil Oil and Lakeland State Bank, who are creditors principally of one entity, would be in a position to recover a larger share of their claim against that entity, who they claim was solvent, than if the cases were ordered consolidated.

Thus, while I conclude that the Debtors meet most of the tests favoring consolidation, the potential prejudice to creditors is too great to permit it at this time, even though I am satisfied that it would be of great benefit to the Debtors to do so.

The Creditors' Committee has also raised an objection to ordering consolidation on the basis that notice to all creditors was not given of the Debtors' Motion, since it is probable that creditors of every entity are not represented on the Creditors' Committee. As noted by the Court in the *Matter of Luth, supra,* on page 568:

> "Notice to all creditors in both proceedings is a prerequisite for consolidation."

Accordingly, it is the order of this Court that the Debtors' Motion for Substantive Consolidation be denied with leave to the Debtors to renew their Motion in the event that later litigation establishes the secured creditors' claims of a secured position in all of the collateral of all of the entities. An order may be entered in accordance with these findings.

IT IS ORDERED that a copy of this Opinion be served upon the attorneys appearing of record at their addresses of record.

DATED: December 19, 1984.

/S/Marvin L. Heitman

Marvin L. Heitman
Bankruptcy Judge

BANKRUPTCY CODE, Section 364
(11 United States Code §364)

(a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1304, 1203, or 1204 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

(b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt —

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.

(d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if —

(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

(e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt or the granting of such priority or lien, were stayed pending appeal.

(f) Except with respect to an entity that is an underwriter as defined in section 1145(b) of this title, section 5 of the Securities Act of 1933 (15 U.S.C. 77e), the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.), and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to the offer or sale under this section of a security that is not an equity security.

Pub. L. No. 95-598, Title I, §364, 92 Stat. 2549, 2574 (1978), as amended by Pub. L. No. 99-554, Title II, Subtitle B, §257(l), 100 Stat. 3088, 3115 (1986).

Bankruptcy Rule 7001

An adversary proceeding is governed by the rules of this Part VII. It is a proceeding: (1) to recover money or property, except a proceeding to compel the debtor to deliver property to the trustee, or a proceeding under §554(b) or §725 of the Code, Rule 2017, or Rule 6002; (2) to determine the validity, priority, or extent of a lien or other interest in property, other than a proceeding under Rule 4003(d); (3) to obtain approval pursuant to §363(h) for the sale of both the interest of the estate and of a co-owner in property; (4) to object to or revoke a discharge; (5) to revoke an order of confirmation of a chapter 11 or chapter 13 plan; (6) to determine the dischargeability of a debt; (7) to obtain an injunction or other equitable relief; (8) to subordinate any allowed claim or interest, except when subordination is provided in a chapter 9, 11, or 13 plan; (9) to obtain a declaratory judgment relating to any of the foregoing; or (10) to determine a claim or cause of action removed pursuant to 28 U.S.C. §1452.